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Deposit Accounts under the New World Order

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ARTICLES

DEPOSIT ACCOUNTS UNDER THE NEW WORLD ORDER

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I. INTRODUCTION

The new world is upon us. Repent. Revised Article 9¹ is the law in every state.² Commercial deposit accounts are now available as original collateral.³ Is this the end of Western Civilization as we know it? We don't think so. Former Article 9 included commercial deposit accounts in some states.⁴ Even in states that excluded deposit accounts from Article 9's scope, deposit accounts served as original collateral. Lenders followed

1. Along with references to Revised Article 9, all references and citations to "Article 9" are to Revised Article 9. We refer to the prior law as "Former Article 9."

2. In all but four states, Revised Article 9 became effective on the proposed promulgation date of July 1, 2001. The four remaining states enacted Revised Article 9 but delayed its effective date beyond July 1, 2001. *See, e.g.*, Connecticut (effective October 1, 2001); Alabama, Florida, and Mississippi (effective January 1, 2002). The Commonwealth of Puerto Rico has yet to consider adoption of Revised Article 9 because it is waiting for the Spanish translation of Revised Article 9. Revised Article 9 has also been adopted in the Virgin Islands, effective April 1, 2002.

3. However, Article 9 excludes assignments of consumer deposit accounts from its scope. U.C.C. § 9-109(d)(13)(2000); *see infra* notes 15-19 and accompanying text.

4. California, Hawaii, Illinois, Idaho and Louisiana included deposit accounts within Former Article 9's scope. Bruce A. Markell, *From Property to Contract and Back: An Examination of Deposit Accounts and Revised Article 9*, 74 CHI.-KENT L. REV. 963, 972-73 (1999).

the common law to take and perfect their security interests.⁵ Moreover, deposit accounts always were (and continue to be) subject to the claims of Article 9 secured creditors as proceeds.⁶ So, the sky is not falling and there is no need to buy locust-repellent, but attorneys do need to understand the new world order. Bringing commercial deposit accounts into the Article 9 fold significantly complicates the planning of an Article 9 secured transaction.

Revised Article 9 replaces the patchwork of common law and statutes that preceded it with a single, seemingly comprehensive set of rules regarding deposit accounts. It describes how to take and perfect a security interest in a commercial deposit account. It details the rights and obligations of: (1) depository banks holding deposit accounts subject to security interests in favor of others;⁷ (2) creditors (including depository banks) holding security interests in deposit accounts as original collateral or proceeds;⁸ (3) debtor-depositors of deposit accounts;⁹ (4) transferees of proceeds of a deposit account;¹⁰ and (5) depository banks as holders of set-off and recoupment rights.¹¹ It provides a labyrinth of priority rules to referee the competing claims to deposit accounts and their proceeds.¹² The priority rules are complicated in part¹³ because secured creditors can claim an interest in a deposit account as original collateral *or* as proceeds. This means the rights of a creditor with a security interest in a deposit account can quickly collide with the rights of a creditor with a security interest in other collateral.

5. According to the Official Comments, leaving deposit accounts to the vagaries of the common law precluded some debtors from using their deposit accounts as collateral because "[t]he common law is nonuniform, often difficult to discover and comprehend, and frequently costly to implement." U.C.C. § 9-109 official cmt. 16 (2000). This was the impetus for including commercial deposit accounts as original collateral under Revised Article 9.

6. Former U.C.C. § 9-104(f) (1995); U.C.C. § 9-109(d)(13) (2000).

7. U.C.C. § 9-341 (2000).

8. U.C.C. §§ 9-327, 9-322(a), 9-324(a), (b), (d) & (e), 9-330(c) (2000).

9. U.C.C. §§ 9-104(b) (2000).

10. U.C.C. § 9-332 (2000).

11. U.C.C. § 9-340 (2000).

12. U.C.C. §§ 9-327, 9-322(a)-(d), 9-324(a), (b), (d) & (e), 9-330(c) (2000).

13. In other part, the priority rules are complicated because *everything* in Revised Article 9 is more complicated. Revised Article 9 is not a quick read on the beach or in your easy chair in front of the fireplace.

For example, assume Lender finances Debtor's inventory. Lender has a perfected security interest in the inventory. Debtor deposits all proceeds from inventory sales into a deposit account with Bank. Bank has a perfected security interest in the deposit account as original collateral. Debtor uses funds from the deposit account to purchase new inventory. Lender's primary collateral (Debtor's inventory) would be proceeds of Bank's primary collateral (Debtor's deposit account) and vice versa. The priority rules governing conflicts regarding proceeds of a deposit account are perhaps the most mind-bending aspect of Revised Article 9.

Attorneys for banks, non-bank creditors and debtors need to understand the new world order and the risks it poses to their clients. They need to develop strategies to minimize those risks so as to protect their clients' positions. Part II of this article describes the new legal framework and some of the risks it creates. Part III explores ways to manage those risks. Appendix A contains an annotated deposit account control agreement form that tries to balance the needs of a secured party holding a security interest in a deposit account with the rights of the bank maintaining the deposit account.

II. TREATMENT OF DEPOSIT ACCOUNTS UNDER REVISED ARTICLE 9

A. *The Players*

In this Part, we seek to explain the Article 9 rules regarding deposit accounts. Identifying the roster of potential players—those who might have an interest in a deposit account—is a helpful beginning point. As under old Article 9, one or more Article 9 secured creditors could claim the deposit account as proceeds of their collateral.¹⁴ The bank maintaining the deposit account could have an interest in the account as an Article 9 secured creditor, as the holder of a set-off right, or both. Another creditor could have a security interest in the deposit account as original collateral. Last, but not least, the debtor, as depositor, has an interest in its

14. Former Article 9 governed deposit accounts as proceeds of a creditor's collateral. Former § 9-102 & 9-104(l) ("This Article does not apply . . . to a transfer of an interest in any deposit account . . . *except as provided with respect to proceeds (Section 9-306) and priorities in proceeds (Section 9-312).* . . .") (emphasis added).

deposit accounts. A deposit account represents the depositor's chose in action.¹⁵ "A bank depositor owns a debt due from the bank."¹⁶

B. *Some Terms—"Deposit Account," "Bank," and "Proceeds"*

1. Deposit Account

According to Section 9-102(a)(29):

"Deposit account" means a demand, time, savings, passbook, or similar account maintained with a bank. *The term does not include investment property or accounts evidenced by an instrument.*¹⁷

Under Revised Article 9, a certificate of deposit (CD) is either an instrument or a deposit account when used as collateral.¹⁸ It is an instrument if it qualifies as an Article 3 negotiable instrument.¹⁹ It is an instrument, even if it does not meet the

15. Markell, *supra* note 4, at 967 ("Banks take title to the funds given them and become debtors; depositors become creditors of the banks with respect to the amount of such funds.")

16. Jason M. Ban, Note, *Deposit Accounts: An Article 9 Security Interest*, 17 ANN. REV. BANKING L. 493, 496 (1998) (quoting Dwight L. Greene, *Deposit Accounts as Bank Loan Collateral Beyond Set-off to Perfection—The Common Law is Alive and Well*, 39 DRAKE L. REV. 259, 267 (1989-90)).

17. U.C.C. § 9-102(a)(29) (2000) (emphasis added).

18. The exclusion of accounts evidenced by an instrument in tandem with § 9-102(a)(47)'s definition of "instrument" helps to resolve the case law controversy surrounding classification of nonnegotiable, nontransferable, and uncertificated CDs. See, e.g., *Bank IV Topeka, N.A. v. Topeka Bank & Trust Co.*, 807 P.2d 686 (Kan. Ct. App. 1991). See, e.g., *In re Cambridge Biotech Corp.*, 178 B.R. 34, 36-37 (Bankr. D. Mass. 1995) (a "non-negotiable" document, by definition, is not an instrument and is a general intangible because it is not anything else); *Bank IV Topeka, N.A. v. Topeka Bank & Trust Co.*, 807 P.2d 686, 690-91 (Kan. Ct. App. 1991) (non-negotiable CD was not a certificated security and was a type of deposit account rather than an instrument); *Cadle Co. v. Citizens Nat'l Bank*, 490 S.E. 2d 334, 339 (W. Va. 1997) (non-negotiable CD is assignable, and therefore an instrument for Article 9 purposes).

19. If the CD qualifies as a negotiable instrument under Article 3 but is accompanied by a security interest or lease in specific goods, the writings, taken together and offered as collateral, would constitute chattel paper. See U.C.C. § 9-102(a)(11) (2000) ("Chattel paper" means a record or records that evidence both a monetary obligation and a security interest in specific goods . . . or a lease of specific goods If a transaction is evidenced by records that include an instrument or

Section 3-104 requirements for negotiability, if those dealing with it treat it like a negotiable instrument. Otherwise, the CD is a deposit account and governed accordingly.²⁰ So, a negotiable CD, when used as collateral, is an instrument, not a deposit account. An uncertificated CD is a deposit account, not an instrument.²¹

Although the definition does not distinguish between consumer and commercial deposit accounts, only non-consumer deposit accounts are available as original Article 9 collateral.²² As Professor Markell notes, Revised Article 9 does not expressly state that commercial deposit accounts are within its scope.²³ The conclusion is based on inference which the Official Comments confirm.²⁴ A deposit account is a chose in action. A chose in action is a kind of personal property. Article 9 governs transactions creating consensual liens in *all* personal property unless the transaction is specifically excluded.²⁵ Section 9-109(d)(13) excludes assignments of deposit accounts in *consumer* transactions.²⁶ Therefore, Article 9 does regulate secured transactions involving deposit accounts in non-consumer,

series of instruments, the group of records taken together constitutes chattel paper.”); 9-102(a)(47) (“‘Instrument’ means a negotiable instrument or any other writing that evidences a right to the payment of a monetary obligation, is not itself a security agreement or lease . . .”).

20. U.C.C. § 9-102 official cmt. 12 (2000).

21. By definition, an uncertificated CD cannot qualify as a negotiable instrument or be treated like one. It is paperless. Because a CD under Revised Article 9 can only be an instrument or a deposit account, a paperless CD, when used as collateral, is a deposit account by a process of elimination.

22. U.C.C. § 9-109(a)(1) & (d)(13) (2000).

23. Markell, *supra* note 4, at 974.

24. U.C.C. § 9-109 official cmt. 16 (2000) (“Except in consumer transactions, deposit accounts may be taken as original collateral under this Article”).

25. U.C.C. § 9-109(a)(1) (2000). Revised Article 9 applies to all transactions creating a security interest in personal property and fixtures except as otherwise provided in Sections 9-109(c) & (d). *Id.*

26. U.C.C. § 9-109(d)(13) (2000). A “consumer transaction” is an Article 9 secured transaction involving an individual. U.C.C. § 9-109(a)(26)(i). The individual must incur the obligation for personal, family, or household purposes. *Id.* The security interest must secure that obligation. U.C.C. § 9-109(a)(26)(ii). The individual must hold the collateral or acquire it primarily for personal, family, or household purposes. U.C.C. § 9-109(a)(26)(iii). In short, a consumer transaction requires a consumer who incurs a consumer debt secured by collateral held or acquired for personal, family, or household purposes. U.C.C. § 9-102(a)(26) (2000). The definition includes “consumer-goods transactions.” *Id.* “Consumer-goods transactions” involve goods used for personal, family, or household purposes as the collateral. U.C.C. § 9-102(a)(24) (2000).

i.e., "commercial," deposit accounts. It also governs deposit accounts, be they consumer or commercial, to the extent they represent proceeds of a creditor's collateral.²⁷

2. Bank

Under Revised Article 9:

"Bank" means an organization that is engaged in the business of banking. The term includes savings banks, savings and loan associations, credit unions, and trust companies.²⁸

This definition aids proper characterization of mutual funds accounts maintained by stock brokerage firms that permit investors to write checks.²⁹ Such property will be investment property, not a deposit account, when used as collateral, if the stock brokerage firm is not engaged in the business of banking.³⁰

Article 9 speaks of "the bank with which the deposit account is maintained."³¹ We refer to this bank as the "depository bank"³² to distinguish it from other creditors, both bank and non-bank, who might have an interest in the deposit account.

27. U.C.C. § 9-109(d)(13) (2000). Although Article 9 does not regulate assignments of deposit accounts in consumer transactions, "[s]ections 9-315 and 9-322 apply with respect to proceeds and priorities in proceeds." *Id.*

28. U.C.C. § 9-102(a)(8) (2000).

29. *See, e.g., State First Nat'l Bank v. Nix (In re Nix)*, 864 F.2d 1209, 1213 (5th Cir. 1989) (holding that a Keogh plan is an Article 9 general intangible, not a deposit account, because: (1) funds withdrawn from Keogh plan are subject to penalty tax; (2) Keogh plan may be funded in whole or in part with stock; (3) the brokerage firm holds plan assets as a fiduciary, rather than as a bank receiving a deposit; and (4) the brokerage firm holding the plan assets was not "a bank" or "like organization.").

30. Some brokerage firms presently own banks and sweep customer funds into FDIC-insured deposit accounts. The rules regarding deposit accounts, not investment property, would govern those deposit accounts. LISSA L. BROOME & JERRY W. MARKHAM, REGULATION OF BANK FINANCIAL SERVICE ACTIVITIES 466 (2001).

31. *See, e.g., U.C.C. § 9-104(a)(1)* (2000).

32. Technically, the term "depository bank" refers to the first bank to take an item. U.C.C. § 4-105(2) (1990). Depending on the situation, the bank maintaining the depositor-customer's account will be the drawee bank or the payer bank. U.C.C. §§ 4-104(a)(8), 4-105(3) (1990).

3. Proceeds

The definition of “proceeds” is also important for understanding the treatment of deposit accounts. The term “proceeds” means the following property:

- (A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;
- (B) whatever is collected on, or distributed on account of, collateral;
- (C) rights arising out of collateral;
- (D) to the extent of the value of collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or
- (E) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.³³

The new and improved definition of proceeds seems designed to capture anything and everything remotely connected to, or derived from, a creditor’s collateral.³⁴ It represents a significant expansion in the class of property qualifying as proceeds.³⁵ Consistent with its new breadth, we assume the revisors wanted the term

33. U.C.C. § 9-102(a)(64) (2000).

34. The definition of “proceeds” suggests that collateral must exist before proceeds can arise. For instance, proceeds are created by the “sale, lease, license, exchange, or other disposition of collateral.” U.C.C. § 9-102(a)(64)(A) (2000). An individual needs collateral before he can have proceeds (of or from that collateral). The new definition of “collateral” suggests otherwise. “‘Collateral’ means the property subject to a security interest or agricultural lien. The term includes: (A) proceeds to which a security interest attaches” U.C.C. § 9-102(a)(12) (2000). Perhaps the revisors were using the definition to establish that all rules regarding collateral also applied to proceeds in the absence of some special rule limited to proceeds. The definitions of “collateral” and “proceeds” produce a logical tangle.

35. Undoubtedly, this expansion was designed in part to supercede case law holding that a partner’s right to distributions from the partnership was not proceeds of the future interest partnership. See, e.g., *In re Mintz*, 192 B.R. 313, 319-20 (Bankr. D. Mass. 1996).

“proceeds” to encompass all forms of property a debtor could acquire through the use of a deposit account. The definition of “proceeds” makes reaching that conclusion a tad awkward.

For instance, assume D contracts to purchase a melting pot from Seller for \$10,000. SP has a valid, perfected security interest in D’s deposit account. D withdraws \$10,000 from its deposit account and pays Seller. Is the melting pot “proceeds” of the deposit account and therefore subject to SP’s security interest? Instinctively, we would say, “Of course.” But that conclusion does not easily flow from Section 9-102(a)(64)’s definition of proceeds. To begin with, D did not acquire the melting pot by a sale, lease, or license of the deposit account. Did D exchange or otherwise dispose of the deposit account when it withdrew the \$10,000? Perhaps. It is not surreal to characterize a reduction in the debt the depositary bank owes to the depositor as an “exchange” or “other disposition” of the deposit account. On the other hand, if we view the deposit account as a contractual relationship between the depositary bank and the depositor, that contractual relationship continues to exist even though a depositor withdraws funds from the deposit account. No exchange or disposition of the relationship occurs.

Could D’s withdrawal of \$10,000 represent a “distribution on account of collateral?” That language seems intended to capture stock splits, stock dividends, partnership distributions to partners, and the like.³⁶ It does not immediately (or even with some prompting) call up images of debtors using funds on deposit to acquire property.³⁷

A deposit account is an obligation a bank owes to its depositor. The depositor has a right to receive payment from a bank. A deposit account is a special kind of “account” or right to payment that Article 9 isolates and treats as a separate form of collateral.³⁸ When a debtor collects payments from its account

36. *See id.*

37. Technically, a depositor’s withdrawal from its deposit account, no matter how it occurs, simply represents a reduction in the obligation the depositary bank owes to its depositor.

38. But for its specific exclusion, Revised Article 9’s definition of “account” would capture deposit accounts. An account is “a right to payment of a monetary obligation . . . for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of . . .” U.C.C. § 9-102(a)(2) (2000). U.C.C. § 9-102(a)(2) expressly excludes deposit accounts. *Id.*

debtors, the collections represent proceeds. By analogy, when a depositor withdraws money from its deposit account, it is arguably *collecting* on its right to receive payment from the depository bank. That collection is proceeds. When the debtor uses it to acquire other property, the other property is proceeds of proceeds. Therefore, the melting pot would be proceeds of the deposit account.

Revised Article 9 did not create this linguistic tangle. Deposit accounts could be cash proceeds under former Article 9³⁹ the same as they can now.⁴⁰ Former Article 9 assumed that property a debtor acquired with the use of cash proceeds was proceeds (of proceeds).⁴¹ Although the issue was present under Former Article 9, it may receive greater scrutiny as deposit accounts move to the center of the stage in Revised Article 9's drama.

The tangle is reminiscent of the definition of "proceeds" under the 1962 Code, which did not expressly include collections on contract rights or rights to payment not yet earned by performance which had not yet ripened into account collateral.⁴² Technically, "proceeds" did not include money, checks or anything else a debtor received by way of payment from its account debtors with respect to such contract rights because such collections did not involve a sale, exchange or other disposition of an account being collected because the account did not yet exist. The 1972 Code fixed the problem.⁴³

39. Former U.C.C. § 9-306(1) (1995).

40. U.C.C. § 9-102(a)(9) (2000).

41. Former U.C.C. § 9-306(3)(a) (1995). Former § 9-306(3), dealing with perfection of a security interest in proceeds, recognized automatic, continuous perfection in identifiable proceeds beyond ten days if the creditor had a perfected security interest in the original collateral, the creditor had filed a financing statement on the original collateral, the creditor would file on the proceeds in the same office or offices where it had filed it on the original collateral, and the proceeds were not acquired with cash proceeds. *Id.* All of this discussion presupposes the property claimed as proceeds is identifiable because a creditor's security interest in proceeds is limited to identifiable proceeds. U.C.C. § 9-315(a)(2); Former U.C.C. § 9-306(2) (1995).

42. U.C.C. § 9-306 (1962); *see also* U.C.C. § 9-204(2)(d) (1962).

43. Former § 9-306(1) defined "proceeds" to include "whatever is received upon the sale, exchange, *collection* or other disposition of collateral or proceeds" and deleted the term "contract right." Former U.C.C. § 9-306(1) (1995) (emphasis added). For similar reasons, the drafters of the 1972 Amendments to Article 9 added language to insure that rights to insurance proceeds covering collateral were proceeds

A charitable court could also conclude that property acquired through the *use* of collateral constitutes proceeds of the collateral.⁴⁴ That expansive interpretation would comport with Revised Article 9's expanded definition of proceeds. The question is the degree of charity Revised Article 9 will inspire among courts, especially bankruptcy courts.

The problem, in part, is how one visualizes a deposit account. Is it a pile of money, a vault, a relationship, a right to payment against a bank? The mental image may affect the analysis.

Article 9 refers to "funds in the account" on at least two separate occasions.⁴⁵ The Deposit Accounts Task Force maintains that by "using [such] language the provisions invite lawyers and courts to treat deposit accounts as trust funds or as cash sitting in a vault, rather than what they are: merely the unsecured obligation of the bank."⁴⁶ Only one thing is certain. Some day, somewhere, some lawyer is going to accept the invitation to treat a deposit account as a trust or as cash sitting in a vault.

"Cash proceeds" is another definition that is key to understanding the treatment of deposit accounts under Revised Article 9. "'Cash proceeds' means proceeds that are money, checks, *deposit accounts*, or the like."⁴⁷

C. *Deposit Accounts as Proceeds*

1. Security Interest in Deposit Account as Proceeds of a Creditor's Collateral

A creditor with a security interest in collateral automatically enjoys a security interest in all *identifiable* proceeds

of collateral. *Id.* ("Insurance payable by reason of loss or damage to the collateral is proceeds except to the extent that it is payable to a person other than a party to the security agreement.").

44. Bankruptcy Code, 11 U.S.C. § 363 (2000), speaks of the sale, *use* or lease of property of the estate. Normally, one *uses* funds or a deposit account. One does not sell or lease a deposit account.

45. U.C.C. §§ 9-332(b), 9-607(a)(4) (2000).

46. John F. Hilson, Bruce A. Markell, Stephen L. Sepinuck & William D. Warren, *Report of the Deposit Accounts Task Force to the Article 9 Drafting Committee*, 54 CONSUMER FIN. L. Q. REP. 203, 209 (2000), WL 54 Consumer Fin. L.Q. Rep. 203.

47. U.C.C. § 9-102(a)(9) (2000) (emphasis added).

of that collateral.⁴⁸ This includes deposit accounts. So the creditor with a security interest in collateral has a security interest in any deposit account representing *identifiable* proceeds of that collateral. This is true whether the deposit account is a consumer or commercial account.⁴⁹

The requirement of identifiability poses problems for the lender when a deposit account contains non-proceeds as well as proceeds. The typical inventory lending agreement will require the debtor to establish a “proceeds only” deposit account and covenant to deposit all proceeds of the lender’s inventory into that account and deposit *only* the lender’s proceeds into that account. What if the debtor violates the security agreement and commingles proceeds with non-proceeds in the deposit account? In order to determine identifiable proceeds, courts under Former Article 9 resorted to common law tracing rules based on constructive trust law, e.g., the lowest intermediate balance rule, to identify a creditor’s secured claim to the commingled funds.⁵⁰ Revised Article 9 expressly validates this judicial practice.⁵¹ Under the new world order, the specter of commingling still threatens a creditor’s secured claim to a deposit account as proceeds of its collateral. In addition to loan covenants prohibiting commingling, creditors need to monitor their debtors to insure they are not commingling.

2. Perfection of Security Interest in Proceeds

a. Automatic Continuous Perfection for Twenty Days

A creditor with a perfected security interest in collateral enjoys automatic, continuous perfection of its security interest in any and all identifiable proceeds for twenty days after its interest

48. U.C.C. § 9-203(f) (2000); Former U.C.C. 9-§ 203(3) (1995).

49. U.C.C. § 9-109(d)(13) (2000). Although consumer deposit accounts cannot serve as *original* Article 9 collateral, they can represent proceeds of collateral. *Id.* Article 9 does not regulate assignments of deposit accounts in consumer transactions, “but Sections 9-315 and 9-322 apply with respect to proceeds and priorities in proceeds.” *Id.*

50. *See, e.g.,* ITT Commercial Fin. Corp. v. Tech Power, Inc., 51 Cal. Rptr. 2d 344, 347 (Cal. Ct. App. 1996).

51. U.C.C. § 9-315(b)(2) (2000).

in the proceeds attaches.⁵² Section 9-315(d) describes when the creditor's perfection will continue beyond the twenty days.

b. Automatic Continuous Perfection Beyond Twenty Days: Cash Proceeds

Perfection will automatically continue beyond the twenty-day period if the proceeds are identifiable *cash* proceeds.⁵³ Deposit accounts, by definition, are "cash proceeds."⁵⁴ Thus, the creditor will have an automatic, continuously perfected security interest in the deposit account if: (1) the deposit account contains identifiable proceeds of the creditor's collateral; and (2) the creditor's interest in the original collateral was perfected.

c. Automatic Continuous Perfection Beyond Twenty Days: Other

According to Section 9-315(d)(1), a creditor's perfection will also extend beyond the twenty-day period if: (1) a filed financing statement covered the original collateral; (2) the creditor would file on the proceeds where the creditor filed on the original collateral; and (3) the proceeds were not acquired with cash proceeds.⁵⁵

Assume Creditor perfects its security interest in Debtor's inventory by filing. Debtor sells the inventory to Buyer in exchange for Buyer's promise to pay in thirty days. Debtor now has an account. Creditor filed on Debtor's inventory in the state of Debtor's location.⁵⁶ If Creditor were to file on Debtor's accounts, it would file in the same place, whether Debtor was a registered organization, a nonregistered organization, or a human being. Therefore, Creditor would have an automatically perfected

52. U.C.C. § 9-315(c) (2000). Needless to say, perfection of a security interest presupposes a security interest. A security interest in a deposit account claimed as proceeds only exists if the proceeds are identifiable. The perils associated with commingled deposit accounts naturally spill over into and affect the question of perfection of a creditor's security interest in a deposit account as proceeds.

53. U.C.C. § 9-315(d)(2) (2000).

54. U.C.C. § 9-102(a)(9) (2000) ("Cash proceeds" means "proceeds that are money, checks, deposit accounts, or the like.").

55. U.C.C. § 9-315(d)(1) (2000).

56. See U.C.C. §§ 9-301(1), 9-307(b) (2000).

security interest in the account beyond the twenty-day period.⁵⁷ The same analysis would hold true if the account debtor paid by using her MasterCard.⁵⁸

What if the buyer-account debtor thereafter pays Debtor by check or cash, and Debtor deposits the check or money into its operating account at Bank? Assume Creditor can trace the funds back to its inventory so the deposit account contains identifiable proceeds. Is Creditor's interest automatically perfected beyond the twenty days? The answer will depend on whether the deposit account was "acquired with cash proceeds?" If it was, Section 9-315(d)(1) will not apply. Section 9-315(d)(1)'s automatic perfection provision does not apply if the proceeds in question were acquired with cash proceeds. We do not know whether depositing funds into an account means that the deposit account was acquired with cash proceeds.

Section 9-315(d)(2) also might give Creditor automatic continuous perfection. It recognizes automatic continuous perfection if the proceeds are identifiable cash proceeds. The deposit account was cash proceeds (and arguably identifiable). The debtor deposited collections on Buyer's account. The account was non-cash proceeds. Does Section 9-315(d)(2) mean a creditor's interest in any identifiable cash proceeds of whatever generation is *always* automatically and continuously perfected so long as the creditor's interest in the original collateral was perfected? Again, we do not know. Section 9-315(d)(2) says nothing about the character of intervening generations of proceeds. Section 9-315(d)(1) does. Arguably, Section 9-315(d)(2) means what it says. If the proceeds in question are identifiable cash proceeds, the creditor's interest is automatically and continuously perfected regardless of the nature of any intervening proceeds.

d. Perfecting an Interest in Proceeds

In all other cases, perfection will extend beyond the twenty-day period only if the creditor's interest in the proceeds is or becomes perfected within the twenty-day period following

57. U.C.C. § 9-315(d)(1) (2000).

58. U.C.C. § 9-102(a)(2) (2000). Revised Article 9 defines "account" to include credit card receivables. *Id.*

attachment.⁵⁹ The only way to perfect a security interest in a deposit account is by control.⁶⁰ One doubts if the creditor could obtain a control agreement or become the depositary bank's customer within twenty days. Therefore, unless the creditor's interest in the second deposit account is automatically perfected under Section 9-315(d)(1) or (d)(2), the creditor risks losing its perfection with all the attending consequences.

D. *Deposit Accounts as Original Collateral*

Only commercial deposit accounts are available as original collateral. The common law continues to govern secured transactions in consumer deposit accounts.⁶¹

1. Attachment

Like other types of personal property, creation of a security interest in a commercial deposit account requires the creditor to give value.⁶² In addition, the debtor must have rights in the deposit account(s).⁶³ The last requirement for attachment is stated in the disjunctive. Either the debtor must authenticate a security agreement providing a description of the collateral⁶⁴ or the creditor must have "control" of the deposit account "pursuant to the debtor's security agreement."⁶⁵

59. U.C.C. § 9-315(d)(3) (2000) ("A perfected security interest in proceeds becomes unperfected on the 21st day after the security interest attaches to the proceeds unless: . . . the security interest in the proceeds is perfected . . . when the security interest attaches to the proceeds or within twenty days thereafter.").

60. U.C.C. § 9-312(b) (2000) provides: "Except as otherwise provided in Section 9-315(c) and (d) for proceeds: (1) a security interest in a deposit account may be perfected only by control under Section 9-314." A creditor perfects its security interest in a deposit account by control pursuant to Section 9-104. U.C.C. § 9-314(a) (2000). There are three different ways to obtain control of a deposit account. U.C.C. § 9-104 (2000).

61. For a discussion of the common law governing how to take and perfect a security interest in a deposit account, see Ban, *supra* note 17, at 497-99.

62. U.C.C. § 9-203(b)(1) (2000).

63. U.C.C. § 9-203(b)(2) (2000) ("debtor has rights in the collateral or the power to transfer rights in the collateral to a secured party").

64. U.C.C. § 9-203(b)(3)(A) (2000).

65. U.C.C. § 9-203(b)(3)(D) (2000).

a. Control Pursuant to the Debtor's Security Agreement—Sections 9-203(c)(3)(D) & 9-104

Attachment of a security interest in a debtor's deposit account does not require an authenticated record evidencing the debtor's intent to create the interest.⁶⁶ It is enough if the creditor has control, as described by Section 9-104, pursuant to the debtor's security agreement.⁶⁷

[I]t is interesting to note that the incorporated definition—security agreement—does not require a writing. A security agreement is simply “an agreement that creates or provides for a security interest.” The definition of “agreement” in Article 1—applicable to Revised Article 9—simply refers to “the bargain of the parties in fact as found in their language or by implication from other circumstances including course of dealing or usage of trade or course of performance.” Thus attachment . . . has no signed writing requirement. As a consequence, a security interest in favor of a bank in a deposit account can arise by implication as well as by express oral agreement—a fact that third party creditors will have to face each time they seek to garnish a deposit account.⁶⁸

Theoretically, then, a creditor can rely on the debtor's oral or even implied agreement to create a security interest in its deposit account. As a practical matter, a creditor would be foolish not to reduce the parties' understanding to a writing or other record. One assumes banks will add a clause to their form deposit agreements in which the customer will grant a security interest in the deposit account to secure any and all obligations the customer

66. Markell, *supra* note 4, at 982. Other subsections of Section 9-203(b)(3) also dispense with the requirement of an authenticated record evidencing the debtor's agreement to create a security interest. *See, e.g.*, U.C.C. § 9-203(b)(3)(B) (2000) (collateral other than certificated security in creditor's possession pursuant to debtor's security agreement); U.C.C. § 9-203(b)(3)(C) (2000) (certificated security delivered to secured party pursuant to debtor's security agreement).

67. U.C.C. § 9-203(b)(3)(D) (2000); U.C.C. § 9-104 (2000).

68. Markell, *supra* note 4, at 982 (footnotes omitted).

owes to the bank. This will give depositary banks greater protection than their common law rights of set-off (banker's lien) and recoupment. A security interest gives its holder the right to all identifiable proceeds of its collateral.⁶⁹ Therefore, a depositary bank with a security interest in its depositor's account has a security interest in all identifiable proceeds of that deposit account.⁷⁰ A bank's set-off right does not extend beyond the account itself (and funds in it). Funds withdrawn from the account diminish the bank's set-off right.

b. Authenticated Security Agreement & Description of Collateral—Section 9-203(c)(3)(a)

Assume the creditor, bank or non-bank does not want to invite litigation over whether the debtor orally or impliedly created a security interest in the deposit account in question. In that case, the debtor must authenticate a security agreement that describes the collateral.⁷¹ Like former Article 9, a description is sufficient under Revised Article 9 if the language used reasonably identifies what is described, whether or not it is specific.⁷² Thus, the agreement must reasonably identify the deposit account(s). The description "general intangibles" will not suffice because "deposit account" is a separate, discrete type of collateral.⁷³ Moreover, a supergeneric description does not reasonably identify collateral for purposes of a security agreement.⁷⁴ Therefore, the

69. U.C.C. § 9-203(f) (2000).

70. The protection a depositary bank receives from having a continuing security interest in identifiable proceeds may prove more illusory than real. See *infra* notes 109-42 and accompanying text.

71. U.C.C. § 9-203(b)(3)(A) (2000).

72. U.C.C. § 9-108(a) (2000).

73. U.C.C. § 9-109 official cmt. 16 (2000).

74. U.C.C. § 9-108(c) (2000) ("A description of collateral as 'all the debtor's assets' or 'all the debtor's personal property' or using words of similar import does not reasonably identify the collateral."). A financing statement can use a supergeneric description, "all assets" or "all personal property," assuming the debtor has authorized the creditor to file it. U.C.C. § 9-504(2) (2000); U.C.C. § 9-509(a) (2000) (stating that person may file initial financing statement only if debtor authorizes filing in authenticated record). A debtor authorizes a filing, by operation of law, when it authenticates a security agreement, but that authorization is limited to "the collateral described in the security agreement." U.C.C. § 9-509(b)(1) (2000). Because supergeneric descriptions are not valid in a security agreement, creditor reliance on an "all asset" financing statement invites litigation over whether the

agreement must take, or provide, for an interest in “all the debtor’s deposit accounts” or specific deposit accounts that are reasonably identifiable based on the words used, e.g., “all debtor’s deposit accounts maintained with BigBank” or “Debtor’s deposit account # 12345-04 maintained at BigBank.”

2. Perfection of Security Interest in Deposit Account as Original Collateral

a. Control: Introduction

Perfection of a security interest in a deposit account as original collateral requires control.⁷⁵ Notice, then, that control can serve two different functions in connection with a deposit account. It can “substitute for an authenticated security agreement as an element of attachment.”⁷⁶ It must exist for the creditor to hold a perfected security interest.⁷⁷ Control therefore plays a key role in secured transactions involving deposit accounts as original collateral.

Section 9-104, captioned “Control of Deposit Account,” poses the three different ways a creditor can have control of a deposit account:

(a) [Requirements for control.] A secured party has control of a deposit account if:

debtor authorized the filing. For example, assume the security agreement described 10 forms of collateral but made no mention of the debtor’s commercial tort claim. The debtor had a tort claim. Did the debtor authorize the filing of the “all assets” financing statement given that the debtor did not grant the creditor a security interest in one of its assets, its commercial tort claim? If the debtor did not authorize it, is it nevertheless effective to perfect the creditor’s interest in collateral that was validly described in the security agreement, or would the financing statement be seriously misleading according to U.C.C. § 9-506(a)(2000)? Who knows? Unless a creditor-client would like to help establish controlling precedent on the issue in its jurisdiction, attorneys should avoid using an “all assets” financing statement.

75. U.C.C. § 9-312(b)(1) (2000) (“Except as otherwise provided in Section 9-315(c) and (d) for proceeds: (1) a security interest in a deposit account may be perfected only by control under Section 9-314); *see also* U.C.C. § 9-104 official cmt. 2 (2000) (“when a deposit account is taken as original collateral, the only method of perfection is obtaining control under this section.”)

76. U.C.C. § 9-104 official cmt. 2 (2000).

77. *Id.*

(1) the secured party is the bank with which the deposit account is maintained;

(2) the debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor; or

(3) the secured party becomes the bank's customer with respect to the deposit account.⁷⁸

So, a creditor has control of a deposit account if: (1) it is the depository bank; or (2) the debtor, the depository bank, and it agree that the bank will follow the creditor's instructions without the debtor's further consent; or (3) it becomes the depository bank's customer regarding the account.⁷⁹

b. Control: Depository Bank

Because a depository bank, by virtue of being a depository bank, has control, Section 9-104(a)(1) recognizes automatic perfection of a depository bank's security interest in deposit accounts maintained with it. Therefore, a depository bank's security interest is perfected when attachment occurs; that is, after it has given value,⁸⁰ the debtor has rights in the deposit account, and the debtor has authenticated a security agreement describing the deposit account or otherwise agreed to give the bank a security interest in the deposit account.⁸¹ The ease with which a depository bank can obtain a perfected security interest in deposit accounts it maintains and the added protection and leverage such a security interest can create suggest that depository banks will routinely take security interests in their depositors' bank accounts. Indeed, in the new world, it is likely that every deposit account will be

78. U.C.C. § 9-104(a)(1)-(3) (2000).

79. *Id.*

80. The definition of value includes a binding commitment to extend credit. U.C.C. § 1-201(44)(a) (1987), and any consideration sufficient to support a simple contract. U.C.C. § 1-201(44)(iv) (1987). This includes a promise to extend credit. A depository bank gives value, then, if it promises to honor a customer's overdrafts.

81. U.C.C. § 9-203(b)(3)(A), (D).

subject to a perfected security interest in favor of the depository bank where such account is maintained.⁸²

c. Control: By Control Agreement

Non-bank creditors can acquire control only through a control agreement or by becoming the bank's customer vis-a-vis the account.⁸³ First let's consider a control agreement. The essence of this authenticated agreement among the debtor, the depository bank and the creditor is that the depository bank will follow the creditor's instructions regarding disposition of account funds. The bank need not obtain the debtor's further consent, i.e., consent over and above the debtor's consent to the control agreement, to heed the creditor's instructions regarding the funds. The creditor has control if the agreement obligates the depository bank to follow the creditor's instructions.⁸⁴

The depository bank's duty to honor the secured creditor's instructions cannot hinge on the debtor's further consent.⁸⁵ The agreement can condition the bank's duty on the observance of specific formalities, e.g., delivery of a certificate of the debtor's default, so long as the bank must follow the creditor's instructions regardless of the certificate's underlying truth or falsity.⁸⁶ The bank must agree to honor the creditor's instructions even if they would represent breach of the creditor's security agreement with the debtor.⁸⁷

82. Markell, *supra* note 4, at 1007; *see also*, First Union National Bank Deposit Agreement and Disclosures for Non-Personal Accounts, Effective May 25, 2001 (on file with the N.C. Banking Institute).

83. U.C.C. § 9-104(a)(2) & (3) (2000).

84. U.C.C. § 9-104(a)(2) (2000).

85. *See* U.C.C. § 9-104(a)(2) (2000) (stating that the parties agree the bank will comply with the secured party's instructions "without further consent by the debtor").

86. U.C.C. § 9-104 official cmt. 3 (2000); U.C.C. § 8-106 official cmt. 7 (1995). The Deposit Accounts Task Force stated that more guidance was needed on "which conditions undermine control and which do not." Hilson, et. al., *supra* note 46, at 206.

87. U.C.C. § 8-106 official cmt. 7 (1995) (discussing control in the context of investment property, states that unfulfilled conditions effective against the intermediary would not preclude the purchaser from having control); U.C.C. § 9-104 (2000) official cmt. 3 (discussing control in the context of a deposit account, refers to Section 8-106 and Official Comment 7, suggesting that its discussion applies to Article 9 as well).

A debtor's ability to reach funds in a deposit account is not, per se, inconsistent with "control,"⁸⁸ although the parties' actual agreement may preclude debtor access to the account, either generally or at the creditor's discretion.⁸⁹ So, a creditor can have "control" even though the debtor can direct the disposition of funds from the deposit account. The Code leaves the actual terms of the control agreement to the imagination of the parties, shaped by their respective needs and practical constraints.

A depository bank has no duty to enter into a control agreement or to disclose its existence.⁹⁰ This means the depository bank has the potential to extract "concessions" from the creditor who wants a control agreement.

d. Control: Creditor Becomes Depository
Bank's Customer

Non-depository bank creditors can also achieve control, and thereby perfect their interest in a deposit account as original collateral, by becoming the depository bank's customer vis-a-vis the account. According to the comments, "[a]s the customer, the secured party would enjoy the right (but not necessarily the exclusive right) to withdraw funds from or close, the deposit account."⁹¹

88. U.C.C. § 9-104(b) (2000) ("A secured party that has satisfied subsection (a) has control, even if the debtor retains the right to direct the disposition of funds from the deposit account.").

89. U.C.C. § 9-104 official cmt. 3 (2000).

90. U.C.C. § 9-342 (2000). This section provides:

This article does not require a bank to enter into an agreement of the kind described in Section 9-104(a)(2), even if its customer so requests or directs. A bank that has entered into such an agreement is not required to confirm the existence of the agreement to another person unless requested to do so by its customer.

Id.

91. U.C.C. § 9-104 official cmt. 3 (2000). The comment refers to U.C.C. Sections 4-401(a) and 4-403(a). Both sections seem to suggest that someone other than the customer of the bank can draw on an account. Article Four defines "customer" as "a person having an account with a bank or for whom a bank has agreed to collect items, including a bank that maintains an account at another bank." U.C.C. § 4-104(5) (1990). Under Article Four of the UCC, "a bank [can] charge against the account of a customer an item that is properly payable from the account even though the charge

e. Control: Secret Lien?

As noted, the creditor with a security interest in a deposit account as original collateral can only perfect its interest by control. As Professor McDonnell observed, “control as a method of perfection is not calculated to give public notice of the security interest.”⁹² Section 9-104(a)(1)’s automatic perfection of the depositary bank’s interest obviously dispenses with any requirement of public notice. Perfection by means of a control agreement is hardly more public. Only the parties to the agreement know about it and the depositary bank is under no duty to disclose its existence.⁹³ Perfection by becoming the bank’s customer is not a public act either. Is this unpublicized lien objectionable? Perhaps not. Even under the old regime, one never knew what evil lurked in a deposit account.

First, a creditor’s interest in a deposit account as proceeds has always created a hidden lien. A financing statement indicating “inventory” or “accounts” (or indeed any type of collateral) will perfect the creditor’s interest in *any* identifiable cash proceeds of that collateral,⁹⁴ including deposit accounts.⁹⁵ The financing statement does not need to claim deposit accounts or even proceeds. Second, the effectiveness of a depositary bank’s right of set-off does not depend on public notice; it exists by operation of law. In describing Section 9-104(a)(1)’s automatic perfection for depositary banks, the Official Comments state:

creates an overdraft. An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and bank.” U.C.C. § 4-401(a) (2000). Article Four also mentions “a [c]ustomer or any person authorized to draw on the account if there is more than one person” U.C.C. § 4-403(a) (2000). These provisions suggest that a creditor-now-bank-customer could agree with the depositary bank to allow the debtor to draw on the account under specified circumstances.

92. JULIAN B. McDONNELL, *UNIFORM COMMERCIAL CODE ANALYSIS OF REVISED ARTICLE 9*, § 9-104, at 89-90 (1999).

93. U.C.C. § 9-342 (2000) (stating that a depositary bank is not required to confirm existence of control agreement to another person unless its customer requests it to do so).

94. Former U.C.C. § 9-306(3)(b) (1995); U.C.C. § 9-315(c)-(d)(2) (2000).

95. Former U.C.C. § 9-306(1) (1995); U.C.C. § 9-102(a)(9) (2000) (“‘cash proceeds’ means proceeds that are money, checks, deposit accounts or the like”).

The effect of this provision is to afford the bank automatic perfection. No other form of public notice is necessary; all actual and potential creditors of the debtor are always on notice that the bank with which the debtor's deposit account is maintained may assert a claim against the deposit account.⁹⁶

Depository banks can assert a claim—a right of set-off—against their depositors' deposit accounts in any event. Their having a security interest as well does not alter the calculus too much. Under the new regime, non-depository bank creditors should assume depository banks have perfected security interests in their depositors' bank accounts.

A filed financing statement serves only to give notice that the indicated collateral *may be* encumbered.⁹⁷ "Further inquiry from the parties concerned will be necessary to disclose the complete state of affairs."⁹⁸ Arguably, the red flag warning on function of a financing statement is met without the need to file one. Historically, deposit accounts have been subject to hidden liens. Those in-the-know recognize that deposit accounts are potentially subject to claims. Due diligence requires further inquiry to determine the actual state of affairs.

E. Priority Rules Regarding Competing Security Interests in Deposit Accounts: Section 9-327

1. Creditor with Control v. Creditor without Control

Revised § 9-327 states the priority rules regarding conflicting *security interests in deposit accounts*.⁹⁹ These rules apply whether the competing creditors claim the deposit account as proceeds or as original collateral.¹⁰⁰ First, the creditor perfected

96. U.C.C. § 9-104 official cmt. 3 (2000).

97. U.C.C. § 9-502 official cmt. 2 (2000).

98. *Id.*

99. U.C.C. § 9-327 (2000). Section 9-340 describes priority between a depository bank's right of set-off or recoupment and a creditor's security interest in a deposit account. U.C.C. § 9-340 (2000); *see supra* notes 94-98, *infra* note 100 and accompanying text.

100. U.C.C. § 9-327 official cmt. 4 (2000).

by control will prevail over those who do not have control.¹⁰¹ This means the creditor with a perfected security interest in the deposit account as original collateral will always prevail over the creditor holding an automatically perfected security interest in the deposit account as identifiable cash proceeds of its collateral.¹⁰² The party with control has priority regardless of when it obtained control or when the competing creditor filed on its original collateral.¹⁰³ Section 9-327(1)'s rule is a departure from Article 9's general rule giving priority to the creditor who was first to file or perfect.¹⁰⁴ The creditor with control enjoys non-temporal priority.

2. Creditor with Control v. Creditor with Control: General Rule

Generally speaking, security interests perfected by control rank "according to priority in time of obtaining control."¹⁰⁵ Thus, the first to obtain control has first priority. For depositary banks, the time of obtaining control would be the time of attachment. That could not occur until the time the debtor authenticated a security agreement describing the deposit account or the time the debtor orally or impliedly provided for a security interest. Given that when a depositary bank acquires control could be significant, it seems all the more important to memorialize the debtor's agreement to create a security interest in an authenticated record. Otherwise the depositary bank could bump into messy proof problems. The priority date for non-depositary bank creditors

101. U.C.C. § 9-327(1) (2000).

102. Control is the only way to perfect a security interest in a deposit account as original collateral. U.C.C. § 9-312(b)(1) (2000). A creditor who does not have control is one of two things: an unperfected creditor or a creditor who is claiming the deposit account as identifiable cash proceeds of its collateral. Either way, the creditor without control is subordinate to the creditor with control. Of course, a creditor can obtain control of a deposit account containing identifiable cash proceeds of its collateral. So, too, a creditor could claim a deposit account (deposit account #2) as identifiable cash proceeds of its original collateral (deposit account #1). In each case, the creditor with control has priority over creditors who do not have control.

103. U.C.C. § 9-327(1) (2000). The revisors refer to this as a "non-temporal priority rule." *See, e.g.*, U.C.C. § 9-322 official cmt. 8 (2000).

104. U.C.C. § 9-322(a)(1) (2000).

105. U.C.C. § 9-327(2) (2000). Dueling between two creditors with control should not occur often. In the form deposit account control agreement attached as Appendix A, we suggest obtaining a specific representation and covenant that the depositary bank has not entered into and will not enter into a control agreement for the benefit of any other secured party. *See* Appendix A, Section D.

would be the date of the control agreement or the date the non-depositary bank creditor became the depositary bank's customer.

3. Creditor with Control v. Creditor with Control: Exceptions

The time that control is obtained does not apply if one of the competing secured parties with control is the depositary bank. In that case, the depositary bank's security interest will prevail unless: (1) the other secured party has obtained control by becoming the depositary bank's customer;¹⁰⁶ or (2) the depositary bank has agreed to subordinate its security interest.¹⁰⁷

4. All Creditors Claiming Deposit Account as Identifiable Cash Proceeds and Relying on Automatic Perfection of Their Security Interest

Section 9-327 does not govern priority when all the contestants are claiming the deposit account as identifiable cash proceeds of their collateral and none has obtained control of the deposit account. In that case, some other Article 9 priority rule will govern. If Article 9's general first-to-file-or-perfect rule controls,¹⁰⁸ the creditor's time of filing or perfection with respect to the original collateral will fix its time of filing or perfection with respect to the proceeds.¹⁰⁹ Therefore, as under former Article 9, the secured party who files or perfects as to the original collateral before any other creditor files or perfects will win.¹¹⁰

106. U.C.C. § 9-104(a)(3) (2000).

107. U.C.C. § 9-339 (2000) (indicating that Article 9 does not preclude a secured party from contractually agreeing to subordinate the priority of its security interest).

108. U.C.C. § 9-322(a)(1) (2000) (competing perfected "liens rank according to priority in time of filing or perfection"). We say "if" because another "non-temporal priority" rule might apply, e.g., superpriority for proceeds of a PMSI in equipment or inventory. U.C.C. § 9-324(a)-(b) (2000).

109. U.C.C. § 9-322(b)(1) (2000).

110. Markell, *supra* note 4, at 988. Generally speaking, Revised Article 9 carries on most of Former Article 9's priority rules. *Id.*

5. Priority of Depositary Bank's Right of Set-Off

Unlike Former Article 9,¹¹¹ Revised Article 9, with one exception, subordinates the creditor holding an Article 9 security interest in a deposit account to the depositary bank's right of set-off.¹¹² Generally, a bank may effectively exercise rights of recoupment and set-off against the secured party.¹¹³ Under the exception, a depositary bank may not set-off against the account when a secured creditor is the bank's customer.¹¹⁴ A right of set-off only exists if parties owe mutual debts. The debts are not mutual when the debtor's secured creditor is the depositary bank's customer. The debtor owes the depositary bank. The depositary bank owes the secured creditor.

Revised Article 9's treatment of security interests in deposit accounts does not appear to affect banks and their common law rights of set-off and recoupment. The effect, if any, lies in permitting secured creditors to encumber deposit accounts at the outset of a lending transaction or to encumber collateral that might otherwise be available to the debtor and/or the debtor's unsecured creditors.¹¹⁵

Can a depositary bank have both a security interest in the debtor's deposit account and a right of set-off against the deposit account? With limited exceptions, yes: "the application of this article to a security interest in a deposit account does not affect a right of recoupment or set-off of the secured party as to a deposit account maintained with the secured party."¹¹⁶ According to the

111. Former Article 9 gave priority to the depositary bank's right of set-off only when the debtor was involved in an insolvency proceeding and the creditor was laying claim to a commingled account. Former U.C.C. § 9-306(4)(d)(i) (1995). Otherwise, it was assumed that the secured creditor prevailed over the depositary bank. Former § 9-201 (1995) ("Except as otherwise provided by this Act a security agreement is effective according to its terms between the parties, against purchasers of the collateral and against creditors."); *see also* *Associates Discount Corp. v. Fidelity Union Trust Co.*, 268 A.2d 330 (N.J. Super. Ct. 1970)

112. U.C.C. § 9-340 (2000).

113. U.C.C. § 9-340(a) (2000).

114. U.C.C. § 9-340(c) (2000).

115. G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 AM. BANKR. INST. L. REV. 3, 45-48 (2001).

116. U.C.C. § 9-340(b) (2000). A depositary bank cannot exercise a right of set-off against a deposit account for which the secured creditor is the customer. U.C.C. § 9-340(c) (2000).

Official Comments, “[s]ubsection (b) makes clear that a bank may hold both a right of set-off against, and an Article 9 security interest in, the same deposit account.”¹¹⁷ Each will not affect or impair the other.¹¹⁸ Of course, a depository bank does not have to do anything to have a right of set-off. It arises automatically at common law. To create a security interest, the depository bank must have control “pursuant to the debtor’s security agreement”¹¹⁹ or obtain an authenticated security agreement from the debtor-depositor.

Is it significant that depository banks can now have a perfected security interest in a deposit account as well as a right of set-off against it? Does that appreciably improve a depository bank’s situation? Yes. A security interest confers greater rights. A bank’s right of set-off does not extend to proceeds of a deposit account. A security interest, of course, does.¹²⁰ Even though that security interest may not enjoy a high priority, it is a security interest. At the very least, that may give the depository bank greater leverage to extract protective terms when it negotiates control agreements with other creditors.

6. Depository Bank as Clear Favorite

The Article 9 priority rules regarding interests in deposit accounts favor the depository bank.¹²¹ The depository bank’s security interest prevails over the interest of everyone other than the secured creditor who becomes the depository bank’s customer.¹²² The risk to other secured creditors is obvious. Whether another creditor takes a security interest in a deposit account as original collateral or enjoys a security interest in the deposit account as identifiable cash proceeds, the creditor takes its interest knowing it will be subordinate to the interest of the

117. U.C.C. § 9-340 official cmt. 2 (2000).

118. U.C.C. § 9-340 official cmt. 3 (2000) (“By holding a security interest in a deposit account, a bank does not impair any right of set-off it would otherwise enjoy.”)

119. U.C.C. § 9-203(b)(3)(D) (2000).

120. U.C.C. § 9-203(f) (2000).

121. The depository bank may be the favorite when it comes to deposit accounts. It is not the favorite regarding proceeds of the deposit account. *See supra* notes 103-20, *infra* notes 122-41 and accompanying text.

122. U.C.C. § 9-327(3)-(4) (2000).

depository bank unless the creditor becomes the depository bank's customer. A debtor could convert all its collateral into cash. The cash has to go somewhere. That "somewhere" is likely to be a bank account. If the debtor deposits the cash into the deposit account, all claimants will be subordinate to the depository bank¹²³ unless a competing creditor is the bank's customer regarding the deposit account.¹²⁴

Of course, into every life a little rain must fall, and the life of the depository bank is no exception. Indeed, the supremacy of its interest is assured only to the extent the funds stay in the deposit account. Once they leave, it is quite a different matter.¹²⁵ For example, "a transferee of funds from a deposit account takes the funds free of a security interest in the deposit account unless the transferee acts in collusion with the debtor in violating the rights of the secured party."¹²⁶ What happens to a depository bank's interest in proceeds of the deposit account is discussed in Part G below.

At a minimum, making the depository bank king of the roost as to its deposit accounts makes the depository bank a player in the process. It enjoys rights, privileges and the leverage that comes with them. Even though the depository bank may lose its top priority position when funds leave the account and become proceeds of it, still, much can be said about having priority to all funds in the deposit account unless the creditor becomes the bank's customer, an unpractical scenario in many cases. At the very least, this gives the depository bank some bargaining leverage. Remember, the depository bank is not required to enter into a control agreement. If its demands are reasonable, it can achieve significantly greater protection than it enjoyed under Former Article 9.

123. This is the case if the depository bank has a security interest in the deposit account. It is also the case if the depository bank is simply asserting its common law right of set-off. U.C.C. § 9-340 (2000). According to the general rule, a "bank with which a deposit account is maintained may exercise any right of recoupment or set-off against a secured party. . . ." U.C.C. § 9-340(a) (2000). A depository bank may not set-off against the account when a secured creditor is the bank's customer. U.C.C. § 9-340 (2000); U.C.C. § 9-104(a)(3) (2000).

124. U.C.C. § 9-327(4) (2000); U.C.C. § 9-104(a)(3).

125. See *supra* notes 108-24, *infra* notes 126-41 and accompanying text.

126. U.C.C. § 9-332(b) (2000).

F. Advantages & Disadvantages of Control by Agreement and Control by Becoming Depositary Bank's Customer

Assume the Article 9 creditor is not the depositary bank and it wants to obtain control. What are the advantages and disadvantages, if any, to obtaining control by becoming the depositary bank's customer? For sure, becoming the bank's customer insures the creditor's priority over the depositary bank as secured creditor¹²⁷ and as holder of a set-off right.¹²⁸ It also obviates the need to negotiate a control agreement with the depositary bank and thereby cuts down on expenses. Furthermore, it eliminates the possibility of competing control agreements. Arguably, it is ideal if the creditor wants to block the debtor's access to the deposit account. It seems unworkable when the debtor needs, and the creditor wants, the debtor to have access to the account. If becoming the depositary bank's customer is not realistic under the circumstances, the Article 9 creditor needs to devise strategies to create the protections it would otherwise get by becoming the depositary bank's customer.

G. Priority Rules Governing Proceeds of Deposit Accounts: Sections 9-322(a), 9-322(c), 9-322(d) & 9-327

1. Introduction

In the normal course of business, debtors will use funds from their deposit accounts to meet their various working capital needs. The issue of priority to proceeds of a deposit account is therefore critically important to creditors with security interests in their debtor's deposit accounts.¹²⁹

A deposit account can yield two potential sets of proceeds: 1) what is paid or transferred from the deposit account to a third party, and 2) what the debtor receives or generates from the payment or transfer. For example, assume Debtor has a deposit account containing \$100,000. Creditor has control by means of a control agreement. Debtor withdraws \$15,000 in cash from the account. Debtor physically delivers the cash to Dealer as payment

127. U.C.C. § 9-327(4) (2000); U.C.C. § 9-104(a)(3) (2000).

128. U.C.C. § 9-340(c) (2000).

129. Markell, *supra* note 4, at 991.

for a new melting pot. The cash given to Dealer, if identifiable, could constitute proceeds of Creditor's collateral, the deposit account. So, too, the melting pot.

Section 9-332 describes Creditor's situation vis-a-vis Dealer. Creditor's interest is cut off absent collusion between Debtor and Dealer (the third party transferee) in violation of Creditor's rights.¹³⁰ The "collusion standard" is the least stringent standard and most protective of transferees.¹³¹ Such "broad protection for transferees helps to ensure that security interests in deposit accounts do not impair the free flow of funds."¹³²

Determining who has priority to what the debtor receives or generates from the use of funds from its deposit account is decidedly more complicated.¹³³ A creditor's top priority to the deposit account does not necessarily translate into top priority to its proceeds. Several different priority rules potentially apply.¹³⁴ Which rule actually governs will depend on the nature of the proceeds and the kind of perfection the creditor enjoys in the proceeds. The five possible priority rules governing proceeds of a deposit account are:

- the creditor's non-temporal priority to the original collateral based on something other than filing carries over to proceeds of the collateral—§ 9-322(c)
- the creditor's control over the deposit account as proceeds establishes its priority to the deposit account—§ 9-322(f), § 9-327
- the creditor who was first to file or perfect as to the original collateral has priority to its proceeds—§ 9-322(a)
- the creditor who was first to file on the proceeds has priority to them—§ 9-322(d)

130. U.C.C. § 9-332(b) (2000) (stating that a transferee of funds from a deposit account takes them free of security interest in deposit account unless transferee acts in collusion with debtor in violating secured party's rights).

131. U.C.C. § 9-332 official cmt. 4 (2000).

132. U.C.C. § 9-332 official cmt. 3 (2000). The Comments also note the importance that finality has occupied in shaping the rules regarding the recovery of payments in our legal system. *Id.*

133. Markell, *supra* note 4, at 993.

134. U.C.C. §§ 9-327, 9-322(a)-(d), 9-324(a), (b), (d) & (e), 9-330(c) (2000).

- the creditor's non-temporal priority to the original collateral based on filing extends to some or all of its proceeds.¹³⁵

2. Non-Temporal-Priority-Regarding-the-Original-Collateral-
Extends-to-Proceeds-of-the-Collateral Rule:
Section 9-322(c)

According to Section 9-322(c), which is subject to some exceptions, a creditor's non-temporal priority to the original collateral based on something other than filing, e.g., control or possession, extends to proceeds of the collateral *if*:

- (1) the creditor's interest in the proceeds is perfected,
- (2) the proceeds are cash proceeds or of the same type as the original collateral, and
- (3) generations of proceeds are involved, all intervening proceeds are cash proceeds, of the same type as the original collateral, or an account relating to the original collateral.¹³⁶

135. See, e.g., U.C.C. § 9-324(a) (2000) (superpriority for PMSI's in equipment and all identifiable proceeds), U.C.C. § 9-324(b) (2000) (superpriority for PMSI's in inventory and all identifiable cash proceeds received on or before delivery to a buyer), U.C.C. § 9-324(d) (2000) (superpriority for PMSI's in livestock and their identifiable proceeds), and U.C.C. § 9-330(c) (2000) (chattel paper purchaser's priority to proceeds).

136. U.C.C. § 9-322(c) (2000).

Except as otherwise provided in subsection (f), a security interest in collateral which qualifies for priority over a conflicting security interest under Section 9-327 [control of deposit account] ... also has priority over a conflicting security interest in:

- (2) proceeds of the collateral if:

- (A) the security interest in proceeds is perfected;
- (B) the proceeds are cash proceeds or of the same type as the collateral; and
- (C) in the case of proceeds that are proceeds of proceeds, all intervening proceeds are cash proceeds, proceeds of the same type as the collateral, or an account relating to the collateral.

U.C.C. § 9-322(c) (2000).

Section 9-322(c) is not limited to deposit accounts. A creditor can have non-temporal priority based on control with respect to electronic chattel paper,¹³⁷ investment property,¹³⁸ and letter-of-credit rights.¹³⁹ Nevertheless, this article is devoted to deposit accounts and we focus on Section 9-322(c)'s requirements as they apply to deposit accounts. The following discussion presupposes that the proceeds are identifiable. A creditor's interest in proceeds is limited to identifiable proceeds.¹⁴⁰

- a. Proceeds are cash proceeds or same type as original collateral—Section 9-322(c)(2)(B)

By definition, a deposit account is cash proceeds.¹⁴¹ Therefore, Section 9-322(c)(2)(B), in the context of a deposit account, is saying the proceeds must be cash proceeds—money, checks, deposit accounts, or the like.

- b. Intervening proceeds are cash proceeds, same type as original collateral or an account relating to the original collateral—Section 9-322(c)(2)(C)

In addition, for the creditor's non-temporal priority to extend to proceeds, all intervening proceeds must be cash proceeds (money, checks, deposit accounts, or the like) or an account relating to the original collateral.¹⁴²

- c. Creditor's interest in proceeds is perfected—Section 9-322(c)(2)(A)

Finally, Section 9-322(c)(2)(A) requires perfection of the creditor's security interest in the proceeds. Assuming the proceeds are identifiable, the creditor will meet this requirement in most

137. See U.C.C. § 9-105 (2000). To our knowledge, electronic chattel paper does not yet exist because the technology for it does not yet exist.

138. See U.C.C. § 9-106 (2000).

139. See U.C.C. § 9-107 (2000). Moreover, a creditor can have non-temporal priority based on possession. See, e.g., U.C.C. § 9-330 (2000) official cmt. 2 (priority of chattel paper purchaser).

140. U.C.C. § 9-203(f) (2000); U.C.C. § 9-315(a)(2) (2000).

141. U.C.C. § 9-102(a)(9) (2000).

142. U.C.C. § 9-322(c)(2)(c) (2000).

cases without further action. A creditor's security interest in identifiable cash proceeds is automatically perfected.¹⁴³

The only fly in the ointment is perfection of the creditor's interest in an account relating to the collateral. First, an account is not cash proceeds so Section 9-315(d)(2)'s automatic perfection provision does not apply. Second, the creditor did not file a financing statement to perfect its interest in the original collateral, the deposit account. Therefore, Section 9-315(d)(1)'s automatic continuous perfection provision does not apply. Unless the creditor's interest in the account is subject to automatic perfection under Section 9-309(2),¹⁴⁴ the creditor will only have twenty days of automatic continuous perfection from the time its interest attaches. It must file a financing statement within that twenty-day period to maintain uninterrupted perfection.¹⁴⁵

Distilling Section 9-322(c) to its essence, the creditor's non-temporal priority to the deposit account will extend to all identifiable money, checks, other deposit accounts and the like if no non-cash proceeds intervene other than an account relating to the deposit account. The creditor's non-temporal priority will also extend to any account (right to payment) relating to the deposit account for twenty days after the creditor's interest attaches. Section 9-322(c), and hence its priority, will apply beyond the twenty days only if the creditor's interest in the account is or becomes perfected within the twenty-day period.

The Official Comments describe Section 9-322(c) as stating a rule regarding "proceeds of non-filing collateral."¹⁴⁶ It applies if the secured party has taken the steps necessary to achieve non-temporal priority over a conflicting security interest in non-filing collateral.¹⁴⁷ A deposit account is non-filing collateral. Cash proceeds are also non-filing collateral. No one checks the UCC

143. U.C.C. § 9-315(d)(2) (2000).

144. This is subject to the old exception regarding isolated assignments of accounts. U.C.C. § 9-309(2) (2000) ("assignment of accounts . . . which does not by itself or in conjunction with other assignments to the same assignee transfer a significant part of assignor's outstanding accounts").

145. One supposes that the creditor with non-temporal priority in the original collateral needs to maintain uninterrupted perfection of its interest in the proceeds to enjoy Section 9-322(c)'s priority although that is not stated.

146. U.C.C. § 9-322 official cmt. 8 (2000).

147. *Id.*

files to determine outstanding claims to money, checks, deposit accounts and the like.¹⁴⁸

3. Exceptions to Section 9-322(c)'s Rule

According to Section 9-322(c), its priority rule is subject to Section 9-322(f). Section 9-322(f) provides that all of Section 9-322's rules "subsections (a) through (e) are subject to . . . the other provisions of this part"¹⁴⁹ Another provision of "this part" is Section 9-327 which gives priority to the creditor with control of the deposit account. Freely translated, Creditor 2, with control of Deposit Account 2, representing cash proceeds of Deposit Account 1, will trump Creditor 1, who had control of Deposit Account 1 and non-temporal priority to it.¹⁵⁰

How much protection does Section 9-322(c) really give then to the creditor with non-temporal priority to the deposit account? Not a whole lot. First, its protection is limited to cash proceeds (and accounts relating to the deposit account). Second, even with respect to cash proceeds, its protection can disappear in the blink of an eye. The debtor can deposit funds into another deposit account. If another creditor, e.g., the depository bank in which the second deposit account is maintained, has control of that deposit account pursuant to the debtor's security agreement, the depository bank has priority to that deposit account. It will trump the prior creditor's claim.

4. First-to-File-on-the-Proceeds Rule for "Filing Collateral": Section 9-322(d)-(e)

Section 9-322(c) does not apply if the proceeds of the deposit account (or proceeds of those proceeds) are something other than cash proceeds or an account relating to the deposit account. Section 9-322(d) states another priority rule regarding

148. The new rule permitting a creditor to file to perfect its interest in an instrument does not alter that reality. U.C.C. § 9-312(a) (2000). The ability to file on instruments protects a creditor's security interest from avoidance under 11 U.S.C. § 544(a) (2000) when its debtor possesses the note(s) or CD(s) and refuses to relinquish them to the creditor. *See, e.g., Citicorp, Inc. v. Davidson Lumber Co.*, 718 F.2d 1030 (11th Cir. 1983).

149. U.C.C. § 9-322(f) (2000).

150. U.C.C. § 9-322 official cmt. 8, ex. 6 (2000).

proceeds of a deposit account. Once again, the rule applies to far more than proceeds of deposit accounts. Subsection (d)'s rule applies if:

- 1) the original collateral is chattel paper, deposit accounts, negotiable documents, instruments, investment property or letter-of-credit rights;
- 2) the creditor perfected its interest in the chattel paper, deposit accounts, negotiable documents, instruments, investment property or letter-of-credit rights by a method other than filing;¹⁵¹ and
- 3) the proceeds are *not* cash proceeds (i.e., the proceeds are not deposit accounts, money, checks or the like), chattel paper, negotiable documents, instruments, investment property or letter-of-credit rights.¹⁵²

Freely paraphrased, if the original collateral was non-filing collateral, the creditor perfected by control or possession (not by filing), and the proceeds are filing collateral, "conflicting perfected security interests in proceeds of the collateral rank according to priority in time of filing."¹⁵³

Section 9-322(d) is an exception to Section 9-322(c). Under subsection (d), the creditor's non-temporal priority to the original collateral does *not* extend to the proceeds. Moreover, Section 9-322(d) is an exception to Section 9-322(a). Priority is not determined by whoever was first to file or perfect regarding the original collateral. Subsection (d) gives priority to whoever *files first regarding the proceeds*:

[T]he first-to-file rule of subsection (d) applies only if the proceeds in question are other than non-filing collateral (i.e., if the proceeds are filing collateral). If the proceeds are non-filing collateral, either the first-to-file-or-perfect rule under subsections (a) and

151. U.C.C. § 9-322(d) (2000).

152. U.C.C. § 9-322(e) (2000).

153. U.C.C. § 9-322(d) (2000).

(b) or the non-temporal priority rule in subsection (c) would apply, depending on the facts.¹⁵⁴

What is going on? An example in the Official Comments to Section 9-322 sheds some light:

SP-1 perfects its security interest in Debtor's deposit account by obtaining control. Thereafter, SP-2 files against equipment, (presumably) searches, finds no indication of a conflicting security interest, and advances against Debtor's equipment. SP-1 then files against Debtor's equipment. Debtor uses funds from the deposit account to purchase equipment, which SP-1 can trace as proceeds of its security interest in Debtor's deposit account. If the first-to-file-or-perfect rule were applied, SP-1's security interest would be senior under subsection (a)(1) and (b), because it was the first to perfect in the original collateral and there was no period during which its security interest was unperfected. Under subsection (d), however, SP-2's security interest would be senior because it filed first. This corresponds with the likely expectations of the parties.¹⁵⁵

Seemingly, subsection (d)'s rule is intended to protect those Article 9 parties who rely on the UCC files to chart their future course of conduct. SP-2, an equipment financier, would not expect its interest in the debtor's equipment to be primed by a non-filing creditor claiming the equipment as proceeds of its non-filed (hidden) lien. If the rule were otherwise, it would significantly

154. U.C.C. § 9-322(d) (2000) official cmt. 9. It states:

Under subsections (d) and (e), if a security interest in non-filing collateral is perfected by a method other than filing (e.g., control or possession), it does not retain its priority over a conflicting security interest in proceeds that are filing collateral. Moreover, it is not entitled to priority in proceeds under the first-to-file-or-perfect rule of subsections (a)(1) and (b). Instead, under subsection (d), priority is determined by a new first-to-file rule.

Id.

155. U.C.C. § 9-322 official cmt. 9, ex. 12 (2000).

dampen the lending ardor (or, at least, increase the cost of credit) of any secured creditor who lends on the strength of "filing collateral."

5. Cosmic Significance of Section 9-322(d) for Creditor with Control of Deposit Account?

What does Section 9-322(d) mean for the creditor with priority to a deposit account based on control? To have priority in proceeds that are "filing collateral,"¹⁵⁶ the creditor must file on that collateral before anyone else does.¹⁵⁷ If it never files or files second, it will not have priority. And worse still, if it never files on the proceeds, it risks losing its security interest entirely if its debtor petitions for bankruptcy relief. A creditor cannot file to perfect its security interest in a deposit account as collateral. If the proceeds are not cash proceeds, Section 9-315 will not give the creditor automatic continuous perfection beyond the twenty-day period. If the creditor does not file at all, and thereafter the debtor files bankruptcy, the creditor will be unperfected as of the commencement of the case. The bankruptcy trustee will avoid the creditor's security interest.¹⁵⁸ If the creditor files more than twenty days after its interest attaches, it risks preference exposure.¹⁵⁹

6. First-to-File-or-Perfect-as-to-Original-Collateral-Governs-Priority-to-Proceeds Rule: Section 9-322(a)-(b)

So far, we have examined two different scenarios: the deposit account to cash proceeds scenario and the deposit account to filing collateral proceeds scenario. We have parsed three different priority rules regarding the proceeds: Sections 9-322(c),

156. Examples of filing collateral include: equipment, inventory, farm products, accounts, general intangibles, commercial tort claims. U.C.C. § 9-310 (2000).

157. Article 9 does not mention what the non-filing creditor's financing statement should say. Would "equipment as proceeds" be sufficient? Could it claim "equipment" without authorization from the debtor? Perhaps a cautious depository bank could require the debtor to authorize an "all assets" filing, but this might cause much squawking from the debtor's other secured creditors.

158. 11 U.S.C. § 544(a) (1998).

159. A gap in the creditor's perfection means the creditor must reperfect. If it reperfects and the debtor seeks bankruptcy relief within 90 days of the date of reperfecting, the creditor's security interest is avoidable as a preference. 11 U.S.C. § 547(b) (1998).

9-327, and 9-322(d). There are yet other variations on the proceeds theme. For instance, what if the proceeds of the deposit account are non-filing collateral, e.g., the proceeds are investment property, chattel paper, instruments, letter-of-credit rights, or negotiable documents?

Section 9-322(c) cannot apply because its application is limited to proceeds that are cash proceeds or an account relating to the original collateral. Investment property, chattel paper, instruments, letter-of-credit rights and negotiable documents are not cash proceeds. Section 9-322(d) also cannot apply because it requires proceeds that are not investment property, chattel paper, instruments, letter-of-credit rights or negotiable documents.¹⁶⁰ Which priority rule governs?

If one of the competing creditors has control of the investment property as proceeds or letter-of-credit rights as proceeds, that creditor will have priority pursuant to Sections 9-328 or 9-329 respectively.¹⁶¹ If one of the competing creditors is a purchaser of chattel paper or an instrument who qualifies for priority under Section 9-330, that creditor will have priority to the chattel paper or instrument as proceeds. If no special priority rule applies, Article 9 comes full circle. The first to file or perfect as to the original collateral has priority.

A similar analysis governs proceeds that are cash proceeds,¹⁶² Section 9-322(c) does not apply to that fact pattern because it requires all generations of proceeds to be cash proceeds, collateral like the original collateral or an account relating to the original collateral. So, too, Section 9-322(d) does not apply because it is limited to proceeds that are not cash proceeds, chattel paper, negotiable documents, etc. Unless one of the competing contestants has control of the second deposit account (which will give it priority according to Section 9-327), some special superpriority rule¹⁶³ or Section 9-322(a)-(b)'s first to file or perfect rule will establish priority to the proceeds.

160. U.C.C. § 9-322(e) (2000).

161. U.C.C. § 9-322(f) (2000). This section establishes that the priority rules stated in Sections 9-322(a) through (e) are subject to "other provisions of this part . . ." *Id.*

162. For example, a second deposit account, that was preceded by filing collateral or collateral that was something other than cash proceeds, like the original collateral or an account relating to the collateral.

163. *See, e.g.,* U.C.C. § 9-324(a) (2000) (stating that superpriority for PMSI in equipment extends to all identifiable proceeds).

The Comments provide an example of when this will occur:

SP-1 perfects its security interest in Debtor's deposit account [Deposit Account #1] by obtaining control. Thereafter, SP-2 files against inventory, (presumably) searches, finds no indication of a conflicting security interest, and advances against Debtor's existing and after-acquired inventory. Debtor uses funds from the deposit account [Deposit Account #1] to purchase inventory, which SP-1 can trace as identifiable proceeds of its security interest in Debtor's deposit account [Deposit Account #1], and which SP-2 claims as original collateral. The inventory is sold and the proceeds deposited into another deposit account [Deposit Account #2], as to which SP-1 has not obtained control. . . . [S]ubsection (c) does not govern priority in this deposit account [Deposit Account #2] [because the inventory proceeds were not cash proceeds, proceeds like the original collateral or an account relating to the deposit account [Deposit Account #1]. Subsection (d) also does not govern, because the proceeds at issue (the deposit account [Deposit Account #2]) are cash proceeds.¹⁶⁴ Rather, the general rules of subsections (a) and (b) govern.¹⁶⁵

7. Recapitulation

Based on the above, we think you will agree. The biggest risk associated with relying on a deposit account as original collateral is not understanding the rules regarding priority to its proceeds.

Section 9-322(c) presupposes a creditor with control of a deposit account and priority to the deposit account according to Section 9-327. Further, the priority it grants is limited to identifiable proceeds. That could be a big limitation if the debtor commingled funds. If the proceeds are identifiable, the creditor's

164. See U.C.C. § 9-322(e) (2000).

165. U.C.C. § 9-322 official cmt. 9, ex. 13 (2000).

priority will extend to all deposit accounts and other cash proceeds unless:

- (1) another creditor obtains control of the second deposit account as proceeds,¹⁶⁶
- (2) someone obtains possession of the money,¹⁶⁷
- (3) a holder in due course obtains the checks,¹⁶⁸ or a purchaser of the checks has priority under Section 9-330; or
- (4) there are intervening proceeds that are not cash proceeds or an account relating to the original deposit account.¹⁶⁹

In addition, the creditor with priority to the original deposit account will have priority to an account relating to the original deposit account for twenty days after the account comes into existence if any and all intervening proceeds are cash proceeds. Its priority will continue beyond the twenty days only if it is or becomes perfected in the account.

In fact, Section 9-322(c) gives limited protection to the creditor with control of the original deposit account. The creditor's priority to proceeds is limited even when the proceeds are identifiable cash proceeds. If all depositary banks take a security interest in their depositor's deposit accounts, all depositary banks will have control over their deposit accounts. If a debtor deposits funds into such an account, the depositary bank will have priority pursuant to Section 9-327.

Section 9-322(d)'s priority rule further underscores the fragility of the creditor's position once funds leave the deposit account. If the proceeds are "filing collateral," priority is pegged to the first to file on the proceeds.

To the extent the proceeds in question are cash proceeds that derive from non-cash proceeds, Section 9-322(c) does not apply. Moreover, Section 9-322(d) will not govern because it does

166. U.C.C. §§ 9-322(f), 9-327 (2000).

167. U.C.C. § 9-332(a) (2000).

168. U.C.C. § 9-331 (2000).

169. U.C.C. § 9-322(c)(2)(C) (2000).

not apply to cash proceeds.¹⁷⁰ This leaves resolution of priority to some other provision.¹⁷¹ If no special priority rule governs, the general first-to-file-or-perfect rules of Sections 9-322(a) and Section 9-322(b) will control.

Section 9-322(a)'s "first in time, first in right" rule is familiar to practitioners who structured transactions under Former Article 9. Unfortunately, its application to deposit accounts will not produce easy to predict outcomes. Resolution of a priority dispute regarding proceeds of a deposit account will turn on the competing claimants' "time of filing or perfection."¹⁷² However, obtaining control of a deposit account is not a public act. No filed financing statement establishes the creditor's priority date. As a result, it will be difficult (if not impossible) for creditors to know, *ex ante*, who will have priority.

Under the new regime, everyone is at risk. Lenders secured by security interests in goods risk subordination of their claims to identifiable cash proceeds to creditors with control of the deposit account into which the cash proceeds are deposited. Creditors with control of a deposit account risk subordination to lenders with a prior filed interest in property the debtor acquires with proceeds of the deposit account. The promised rose garden brings many thorns with it.

III. PRACTICAL SOLUTIONS FOR MANAGING THE RISK OF SUBORDINATION

Revised Article 9's treatment of deposit accounts is complex. The risk of failing to understand that treatment is profound—subordination to another secured party. How should a secured creditor manage this risk of subordination? First, it should determine, as a practical matter, whether its proposed transaction involves such a risk. Is its security interest likely to become entangled with the security interest of another secured party? If so, it should quantify the magnitude of the risk. If it is significant,

170. U.C.C. § 9-322(e) (2000) (stating that U.C.C. § 9-322(d) does not apply if the proceeds are cash proceeds).

171. *See, e.g.*, U.C.C. § 9-327(1) (2000) (party in control of deposit account has priority to it); U.C.C. § 9-324(a) (2000) (creditor with PMSI in equipment who files within 20 days has priority to all identifiable proceeds of its collateral).

172. U.C.C. § 9-322(a)-(b) & official cmt. 8, ex. 11 (2000).

the secured party should take steps to minimize or at least manage that risk.

A. Priority Contests Do Not Threaten Every Security Interest

Some security interests are less likely than others to become embroiled in priority disputes. For example, assume Widget Co. asks General Finance Company for a loan. Because Widget Co. is a small business with a history of uneven earnings, General Finance Company limits the amount of the loan to 50% of the fair market value of Widget Co.'s assets (an "asset-based loan"). Furthermore, General Finance Company takes a security interest in all of Widget Co.'s assets. Finally, General Finance Company requires Widget Co.'s customers to mail payments to a post office box under the sole dominion and control of General Finance Company (a "lockbox"). Upon receipt of such payments, General Finance Company cashes the checks and deposits the payments into a deposit account (the "concentration account") that is maintained in the name of General Finance Company by Big Bank.¹⁷³ In this case, in addition to being over secured (always a good idea for the cautious secured party), General Finance Company has eliminated virtually all risk of subordination because it has eliminated the possibility of competing security interests.¹⁷⁴

Widget Co.'s inventory sales will give rise to accounts. Because General Finance Company has a blanket security interest, it will have a security interest in the account both as original collateral and as proceeds of the inventory.¹⁷⁵ Once the account debtor pays the account (by mailing a check to the lockbox), and the funds are deposited into the concentration account, General Finance Company will have a security interest in the deposit account, both as original collateral,¹⁷⁶ and as proceeds of the inventory and the account.¹⁷⁷ Most importantly, the depository bank will not have any set-off rights to the deposit account with respect to the obligations of Widget Co. because General Finance

173. In this example, General Finance Company is not a bank.

174. All our examples assume there are no liens, consensual or non-consensual, when the secured party files its financing statement.

175. U.C.C. §§ 9-203, 9-310(a), 9-501, 9-315(a)(2) (2000).

176. U.C.C. §§ 9-203(b)(3)(D), 9-104(a)(3), 9-310(b)(8) (2000).

177. U.C.C. §§ 9-315(a)(2), 9-315(d)(2) (2000).

Company is the depository bank's customer with respect to the concentration account.¹⁷⁸ Periodically, General Finance Company will draw funds from the concentration account to pay down outstanding loans. It never has to worry about the knotty priority rules applicable to the proceeds of a deposit account.¹⁷⁹

B. Most Security Interests Are at Risk to Priority Challenges

1. Non-Asset-Based Loans

Asset-based loans are expensive, and they also limit a debtor's ability to manage its own cash and deposit accounts. Therefore, a debtor will try to obtain less onerous financing as soon as its credit profile will permit. If the lender moves away from an asset-based loan and the jealous protection it provides, it will do so at a price.

To illustrate, assume Big Widget Co. approaches Regional Bank for a loan. Regional Bank agrees to make the loan on a secured basis. Big Widget Co. grants Regional Bank a blanket security interest, but requests the flexibility to maintain deposit accounts with National Bank which has branch offices in areas Regional Bank does not serve. As Widget Co.'s inventory sales generate accounts, Regional Bank's priority remains intact.¹⁸⁰ But, as soon as the proceeds of such accounts are deposited with National Bank, Regional Bank's security interest in those proceeds will be subordinated to the set-off rights and security interest of National Bank.¹⁸¹ If National Bank is a significant creditor of Big Widget Co., Regional Bank has a big problem.

178. U.C.C. § 9-327(4) (2000). If another creditor had a security interest in the deposit account, Section 9-327(4) would give General Finance Company's interest priority, but no other creditor could have a security interest in the deposit account given how General Finance Company structured the transaction. *Id.*

179. Because Widget Co. cannot draw funds from the concentration account, it must fund its day-to-day working capital needs by requesting additional advances under its loan from General Finance Company.

180. U.C.C. §§ 9-315(a)(2), 9-315(d)(1), 9-322(a)-(b) (2000); see *supra* notes 38-50 and accompanying text.

181. U.C.C. § 9-327(4) (2000). We are assuming National Bank is a rational commercial actor and risk-averse. As such, it will take a security interest in each commercial deposit account it maintains. *Id.*

2. The Depositary Bank as Secured Party

Does National Bank have any problems of its own? As long as the funds remain in the deposit account, its priority to them will remain supreme.¹⁸² Unfortunately for National Bank, its security interest is anything but secure.¹⁸³ As soon as Big Widget Co. withdraws funds to purchase more inventory, Regional Bank will once again ascend to the top of the priority hill, leaving National Bank with a security interest in a significantly less valuable deposit account.¹⁸⁴

3. The Secured Equipment Financier

Not surprisingly, the secured party who takes a security interest in a specific, limited type of collateral is most at risk. Assume Widget Co. has a loan from Big Bank that is secured by a security interest in virtually all of Widget Co.'s assets. The only assets excluded from Big Bank's security interest are widget polishers financed by Equipment Financing Company. One month, Widget Co. gets a little short on cash and sells one of its polishers. The proceeds of that sale are deposited into a deposit account maintained with Cash Bank. As soon as the proceeds are deposited with Cash Bank, Equipment Financing Company's security interest in the proceeds will be subordinate to Cash Bank's set-off rights.¹⁸⁵ If Widget Co. later withdraws funds to purchase inventory, Equipment Finance Company will find its security interest in the proceeds entangled with Big Bank's blanket security interest in inventory.

C. *Quantifying the Risk*

The next step in quantifying the risk of a priority contest is to conduct a thorough due diligence review of the facts and circumstances surrounding the debtor's other financial obligations.

182. U.C.C. § 9-327(4) (2000); *see supra* notes 102-06 and accompanying text.

183. U.C.C. §§ 9-322(d); § 9-322(a)-(b); § 9-327 (2000); *see supra* notes 109-42 and accompanying text.

184. *Id.*

185. U.C.C. § 9-340(a) (2000).

1. Looks Like a Problem, But It's Not

Assume Widget Co. borrows money from Trust Bank. Widget Co. grants Trust Bank a blanket security interest in inventory, accounts and equipment to secure repayment of the loan. Once proceeds from the sale of inventory or the collection of accounts are deposited into Widget Co.'s deposit account, Trust Bank's security interest in such proceeds will be subordinated to the depository bank's rights of set-off. But the actual impact of this subordination may be minimal if Widget Co. does not owe significant obligations to the depository bank.

Similarly, assume Giant Widget Co. is able to borrow money on an unsecured basis. Further, Giant Widget Co. maintains its only deposit account (a cash management account) with Strong Bank. As a matter of standard procedure, Strong Bank takes a security interest in the deposit account.¹⁸⁶ In this instance, Strong Bank probably does not need to worry about the priority of its security interest in proceeds of the deposit account because no other secured creditors exist to challenge Strong Bank's claim.¹⁸⁷ Further, because Giant Widget Co. maintains its only deposit account with Strong Bank, Giant Widget Co.'s funds will be concentrated in that account.

2. Beware of Problems Lurking in the Shadows

A thorough due diligence review may also reveal potential problems with otherwise favorable credit structures. Take, for example, the situation in which Mid-Market Widgets has engaged Agent Bank to form a syndicate of lenders to provide a revolving credit facility. Although Mid-Market Widgets is growing fast, the lending syndicate requires that Mid-Market Widgets grant a blanket security interest to Agent Bank (including the main cash management deposit account of Mid-Market Widgets maintained at Agent Bank), in its capacity as agent, for the benefit of the syndicate members. At first blush, the priority of Agent Bank's

186. *Id.*

187. But remember that priority is only one of several considerations. Depending on the form of the proceeds, Strong Bank's perfection may lapse after 20 days. U.C.C. § 9-315(d) (2000). Further, Giant Widget Co. could always grant a security interest to a new lender in the future.

security interest seems secure. Unfortunately, Agent Bank neglected to find out that Mid-Markets Widgets also maintains a second deposit account with Town Bank, one of the syndicate members. Absent an agreement to the contrary, Town Bank's security interest in the second deposit account (including any proceeds of the collateral subject to Agent Bank's security interest) would have priority over Agent Bank's security interest.

D. Strategies for Managing Priority Risks

To the extent the new priority rules present a meaningful risk to a proposed transaction, the secured party needs to develop strategies for minimizing the risk. Possibilities include overriding the Article 9 priority rules with contractual subordination and intercreditor agreements¹⁸⁸ or restructuring the transaction to eliminate or reduce the risk of priority contests. In the following sections, we give specific examples of how to use these strategies separately, or in concert, to develop a balanced approach that addresses the concerns of all the interested parties. A tempered approach leading to a mutually agreeable solution is preferable to the results the new priority rules will produce if left to operate on their own.

1. Protecting the Rights of the Holder of a Blanket Security Interest

To understand how to protect the rights of a holder of a blanket lien, it is helpful to review the basics of creating an enforceable security interest in a deposit account.

a. Perfection and Attachment

As noted, the attachment and perfection of a security interest in a deposit account are conditioned upon the secured party obtaining control of the deposit account.¹⁸⁹ A secured party can obtain control by:

188. U.C.C. § 9-339 (2000) (stating that Article 9 “does not preclude subordination by agreement by a person entitled to priority”).

189. *See supra* notes 51-85 and accompanying text.

- (1) maintaining the deposit account as the depositary bank;
- (2) entering into an agreement with the debtor and the depositary bank whereby the depositary bank agrees to follow the instructions from the secured party with respect to the disposition of the deposit account without the need for the debtor's further consent; or
- (3) becoming the depositary bank's customer for such deposit account.¹⁹⁰

A secured creditor can eliminate many (if not all) of the priority risks described above if it maintains the deposit account or becomes the depositary bank's customer.¹⁹¹ Unfortunately, this is not always a practical solution because the debtor may insist on maintaining its existing depositary relationships. Also, not every secured lender is a depositary bank. In those situations, the secured party will need to enter into a control agreement with the debtor and the depositary bank.¹⁹²

b. Negotiating Dynamics—Bank Agency Agreements under Former Article 9

The concept of "control" as a necessary element of an enforceable security interest in a deposit account pre-dates Revised Article 9. Under the common law regime that existed prior to Revised Article 9, many secured parties attempted to take control over deposit accounts by means of a bank agency agreement with the depositary bank maintaining the deposit account.¹⁹³ We think the types of issues and negotiating strategies that occur in connection with depositary bank agency agreements illustrate the types of negotiating dynamics that secured creditors will encounter in connection with requests for control agreements.

190. See *supra* notes 65-85 and accompanying text.

191. See *supra* notes 86-101 and accompanying text (describing security interests that are not susceptible to priority disputes).

192. See Markell, *supra* note 4, at 987. This method is the most likely way of obtaining control when the debtor needs access to the deposit account. *Id.*

193. See Alvin C. Harrell, *Security Interests in Deposit Accounts: A Unique Relationship between the UCC & Other Laws*, 23 U.C.C. L.J. 153, 176-78 (1990).

Historically, depositary banks often refused requests for a bank agency agreement. They did not want the perceived additional risk and cost associated with maintaining such agreements. They also viewed such agreements as one-sided in favor of the secured party.¹⁹⁴ Revised Article 9 removes some of the potential for lopsidedness. It strengthens the depositary bank's negotiating position by according the depositary bank's set-off rights priority over a secured party's security interest in proceeds traced to the deposit account.¹⁹⁵ Revised Article 9 specifically codifies a depositary bank's right to refuse to enter into a control agreement, even at the depositor's request.¹⁹⁶

c. Negotiating Dynamics—Control Agreements under Revised Article 9

Because depositary banks will negotiate from a position of strength under the new Article 9, secured parties are going to find it more difficult to obtain the depositary bank's consent to a control agreement. A balanced control agreement that benefits the depositary bank as well as the secured party is the secured creditor's only hope. Otherwise, its request for a control agreement is doomed.

d. Convincing the Reluctant Depositary Bank to Sign on the Dotted Line

Crafting a balanced control agreement requires the secured party to understand and appreciate the depositary bank's concerns. The depositary bank is concerned about: 1) managing the depositary relationship with its depositor; and 2) insuring payment of all its service charges, fees, expenses, reimbursement for returned and uncollected items, and reversals or cancellations of electronic fund transfers. Therefore, a balanced control agreement should acknowledge that the deposit account is subject

194. This is especially true in highly leveraged or otherwise risky transactions. To insure repayment of its loan, the secured creditor will typically demand complete dominion and control over the deposit account including total subordination or waiver of the depositary bank's right of set-off.

195. U.C.C. § 9-340(a) (2000)

196. U.C.C. § 9-342 (2000).

to a separate deposit agreement which will continue to govern the depositary relationship between the depositor and the depositary bank.¹⁹⁷

A balanced control agreement will not require the depositary bank to subordinate its rights of set-off regarding the depositor's obligations with respect to the deposit account unless the secured party expressly agrees to indemnify and reimburse the depositary bank for such amounts.¹⁹⁸ The agreement should limit such indemnification and reimbursement rights to the amount the depositary bank is unable to recover from the debtor.¹⁹⁹ The creditor's agreement to balanced indemnification and reimbursement obligations will effectively provide the depositary bank with a credit enhancement of the depositor's obligations. In exchange, the creditor can reasonably expect the depositary bank to agree to waive or subordinate its security interest in the deposit account in addition to agreeing to the basic elements of control as required by Section 9-104.

A well-drafted control agreement will also require the depositary bank to confirm that no prior control agreement exists regarding the applicable deposit account.²⁰⁰ In addition, the depositary bank should covenant that it will not enter into any other subsequent control agreement.²⁰¹ These provisions will ensure that no competing secured party does or will hold a secret lien on the deposit account.

e. Special Circumstances—The Secured Syndicated Loan

Syndicated lending transactions are one area in which secured parties often fail to maximize their chances of obtaining effective deposit account control agreements. Often, the debtor will maintain deposit accounts with various members of the

197. See Appendix I, Paragraph (A) (Statement of Purpose).

198. See Appendix I, Paragraph (G) (Waiver of Right of Set-Off and Subordination of Security Interest by the Depositary Bank), and Paragraph (H) (Limited Right of Set-Off of the Depositary Bank).

199. *Id.*

200. See U.C.C. § 9-342 (2000) (depositary bank must reveal existence of control agreement if customer requests it to do so); see also Appendix I, Paragraph (E) (Control).

201. See Appendix I, Paragraph (E) (Control).

lending syndicate.²⁰² As noted, a depositary bank's security interest in deposit accounts it maintains is automatically perfected.²⁰³ To ensure that all syndicate members share in this security, the syndicated loan documents should include control provisions for each such deposit account. Each depositary bank/syndicate member should agree to subordinate any security interest securing a non-syndicated obligation it might have in any such deposit account. Syndicate members are accustomed to the requirement that they will share all collateral securing the common syndicated loans on a *pro rata* basis. Raising these issues in the loan documents will make it difficult for a depositary bank to reject such provisions without appearing to want an unfair priority claim to its deposit account. Furthermore, this approach ensures consistent treatment for all depositary bank/syndicate members.

f. What to Do If the Depositary Bank Will Not Give Up Control

Sometimes not even the offer of a balanced approach will convince a reluctant depositary bank to agree to a control agreement. In that case, the secured party must determine if it can underwrite the transaction without a perfected lien on the deposit account as original collateral. The secured party must also remember that a depositary bank's set-off rights are no longer subordinated to the creditor's security interest in the deposit account as proceeds.²⁰⁴ Therefore, failure to obtain a control agreement with appropriate subordination and intercreditor provisions will mean loss of priority in any proceeds deposited in the deposit account.²⁰⁵ If the risk of subordination is unacceptable, the secured party has two choices. Either it can require the debtor to maintain the deposit account with the secured party (if such secured party is a depositary bank) or maintain it with a more cooperative depositary bank, or it can decline to make the loan.

202. Often a bank will join a lending syndicate because it already has other banking relationships with the borrower.

203. U.C.C. §§ 9-310(b)(8), 9-104(a)(1) (2000); *see supra* notes 70-71 and accompanying text.

204. *See supra* notes 102-06 and accompanying text.

205. *Id.*

If the secured party is willing to move forward with the transaction despite the risk of subordination, it can reduce the significance of the risk through conservative structuring of the loan covenants. More specifically, the loan agreement should: 1) prohibit the debtor from incurring any significant obligations to the depositary bank, and 2) prohibit the debtor from entering into a control agreement for the benefit of any other secured party. The secured party should also conduct a thorough due diligence review of the transaction. This review should verify that no UCC-1 financing statements are on file naming the debtor as "debtor" and the depositary bank as "secured party."²⁰⁶ Further, the secured party should confirm that no other secured party has control of the deposit account.²⁰⁷

2. Protecting the Security Interest of the Depositary Bank

a. What Obligations are Secured Anyway?

Funds in a deposit account represent a liability of the depositary bank to its depositor; however, liability can go the other way as well. A depositor may owe the depositary bank significant liabilities as a result of the depositary relationship. These include the depositor's obligation to reimburse the depositary bank for returned and uncollected items and/or reversals or cancellations of electronic fund transfers as well as its duty to pay the depositary bank's service charges, fees, and expenses.

Historically, depositary banks have relied on the common law right of set-off (banker's lien) to secure payment of these obligations. Revised Article 9 gives depositary banks an additional way to secure this credit exposure and to secure other depositor obligations as well. Unfortunately, the sense of security Revised Article 9 creates for depositary banks may prove false.

206. See U.C.C. § 9-315(d)(3) (2000). The creditor who perfects its interest in proceeds within 20 days of attachment enjoys automatic continuous perfection. *Id.* Assuming the proceeds are "filing collateral," a depositary bank can maintain uninterrupted, continuous perfection of its interest in proceeds by filing a financing statement on the proceeds. See *supra* notes 109-42 and accompanying text; see also *supra* note 178 and accompanying text.

207. U.C.C. § 9-342 (2000) (stating that a depositary bank must reveal existence of control agreement if depositor requests it to do so); see Appendix I, Paragraph (E) (Control).

The depositary bank's position of supremacy is extremely fragile given the ease with which a depositor can transfer funds out of a deposit account and the uncertainty of its priority to proceeds of a deposit account.

b. Improving the Depositary Bank's Position with respect to Proceeds—Revised Article 9 Provides Little Help

Priority to proceeds of a deposit account is problematic. Several possible strategies suggest themselves, but none provides much practical assistance.

First, a depositary bank could file a financing statement staking its claim to proceeds of the deposit account. Such a filing would fix the time of filing for purposes of determining priority regarding proceeds under Section 9-322(d).²⁰⁸ But that would only help if the financing statement claimed "all assets of the debtor constituting proceeds of the debtor's deposit account maintained with the secured party." One can only imagine the debtor's irate phone calls to the depositary bank when the debtor learns the bank effectively took a blanket security interest in all its assets, not to mention the objections of the debtor's other secured creditors.

Furthermore, a filed financing statement will not protect the depositary bank's priority to proceeds of its deposit account when the proceeds end up in another deposit account with a different depositary bank. The first depositary bank could only maintain priority with respect to those proceeds by obtaining a control agreement (with subordination and intercreditor provisions) from the second depositary bank. Because the second depositary bank has the same concerns as the first depositary bank, it would likely greet the first bank's request for a control agreement with bemusement or a request for a reciprocal control agreement.

c. If You Want Something Done Right, Do it Yourself

One practical solution would be to limit the debtor's other depositary relationships. The concerned depositary bank could provide the debtor with comprehensive cash management services, which would concentrate funds in the cash management

208. U.C.C. § 9-322(d) (2000).

account. The debtor would not have funds dispersed in several different accounts maintained with different depository banks. Comprehensive cash management services may even eliminate the need for the debtor to maintain other deposit accounts.

Another practical solution would have the depository bank carefully monitoring the daily transactions processed through the deposit account. That would ensure that the debtor's obligations regarding the deposit account do not exceed the limits set by the initial credit approval obtained when the deposit account was opened.

d. You Can't Get Something for Nothing

Every request to enter into a control agreement for the benefit of a secured party gives the depository bank a means for obtaining credit enhancement for the depositor's obligations to the depository bank.²⁰⁹ Credit enhancement results from requiring the secured party to agree to indemnify and reimburse the depository bank for any of the depositor's unsatisfied obligations with respect to the deposit account. Assuming the secured party holds a blanket security interest, it will have other assets to secure the debtor's obligations, making it generally amenable to the depository bank's request. Because the failure to obtain a control agreement will cut a large hole in the secured party's blanket security interest, the secured party may have no choice but to accept the bank's terms.²¹⁰ Nevertheless, the depository bank should not push its demands for indemnification and reimbursement too far. If the price for obtaining a control agreement becomes too high, the secured party may force the debtor to move the deposit account to a more cooperative depository bank.

3. Protecting a Security Interest in Specific Collateral

Historically, secured parties with a security interest in specific collateral have typically requested written releases of

209. See *supra* notes 163-66 and accompanying text.

210. Notably, the depository bank has even more leverage when the creditor requesting a control agreement is *not* a bank, and therefore cannot maintain the deposit account itself.

competing security interests in such assets.²¹¹ Although this will continue to be the prudent course of action under Revised Article 9, it is doubtful that depositary banks will agree to or even expect such requests. Quite simply, the reasons that lead senior lenders agree to such releases do not apply to depositary banks.

a. Control Will Likely Not Be an Option

Collateral-specific creditors could also request a control agreement, but it will probably not work. In all likelihood, the depositary bank has already entered into a control agreement with the debtor's senior lender and promised not to enter into a control agreement with any other party.²¹² Lenders, such as equipment vendors, will also likely lack the clout to force a relocation of the debtor's deposit accounts. In fact, the deposit account might be maintained by the debtor's senior lender.

b. Rely on a Conservative Structure

Absent control, the secured party will need to rely on protective transaction structures. Lockboxes and concentration accounts are necessary to maintain priority with respect to proceeds of inventory and accounts. Further, equipment financiers need to limit the disposition of equipment subject to their security interest. They should also require specific assignments of the proceeds of insurance policies covering their collateral. In short, Revised Article 9 requires the careful secured party holding a security interest in specific assets to exercise greater vigilance to protect its priority to proceeds.

E. *The Debtor's Point of View*

The above discussion might suggest the debtor/depositor plays the role of passive participant in this drama. Nothing could

211. Holders of blanket security interests are not only familiar with these requests, but typically amenable to them. Blanket security interest lenders enjoy a large collateral base. Carving out a small portion of their collateral permits the debtor access to other sources of financing. This third party financing helps to fund the growth of the debtor's business which redounds to the benefit of the senior lender.

212. See *supra* notes 163-66 and accompanying text.

be farther from the truth. The rational depositor has selected its depositary banks for a reason and wants to maintain control over those relationships. Further, no debtor wants its financing transactions to be held hostage by disputes between its depositary bank and secured lender with respect to control agreements. These disputes do nothing but increase the borrower's transactional costs.

Debtor sensitivity to the negotiation dynamics surrounding control agreements as well as to the benefits of balanced control agreements can avoid these problems. Debtors should also recognize the value of facilitating the negotiation of a balanced control agreement between their depositary bank and their senior lender. Debtors should consider coordinating their depositary relationships with their senior lenders. The more valuable a debtor's overall banking relationship with a depositary bank, the more leverage a debtor will have to manage the resolution of disputes concerning control agreements. Finally, debtors can reduce the magnitude of the risk of subordination for their senior lender by limiting the scope of the depositary bank's security interest to obligations directly relating to the deposit account.

IV. CONCLUSION

A new world is indeed upon us. Inclusion of commercial deposit accounts as original collateral and the depositary bank's new and improved rights under Revised Article 9 pose new wrinkles and new threats. Secured creditors would be well-advised to plan their transactions with these new rules in mind or they will come to repent on judgment day.

V. APPENDIX A

**ANNOTATED DEPOSIT ACCOUNT CONTROL
AGREEMENT**

Note: Deposit Account Control Agreement provisions are printed in italics and commentary is printed in regular font.

DEPOSIT ACCOUNT CONTROL AGREEMENT (this "Agreement"), dated as of _____, 200_, by and among [____], a [____] corporation (the "Grantor"), [____] (the "Depository Bank"), and [____], as Administrative Agent (in such capacity, the "Administrative Agent") for the ratable benefit of the banks and other financial institutions (the "Lenders") from time to time parties to the Credit Agreement, dated as of _____, 200_ (as amended, restated, supplemented or otherwise modified from time to time, the "Credit Agreement"), by and among the Grantor [Insert name of Borrower if not Grantor], [as Borrower,] the Lenders, and the Administrative Agent [Other applicable Loan Documents]. Capitalized terms used herein and not defined shall have the meaning assigned to such terms in the Credit Agreement.

A. Definition of Deposit Account.

STATEMENT OF PURPOSE

The Depository Bank acknowledges that it is an organization that is engaged in the business of banking and that as of this date it maintains the demand, time, savings, passbook or similar cash deposit accounts identified on Schedule I hereto in the name of the Grantor (such cash deposit accounts, together with all funds contained in such deposit accounts from time to time, the "Controlled Accounts"), which are governed by the terms and conditions of the [Deposit Account Agreement] dated _____ between the Grantor and the Depository Bank (the "Deposit Agreement").

The Grantor has assigned and granted to the Administrative Agent a pledge and security interest in the Controlled Accounts and all funds on deposit therein to secure the Grantor's obligations to the Administrative Agent and the Lenders under the [Credit Agreement]. [Other applicable Loan Documents].

Commentary

This particular Deposit Account Control Agreement contemplates a syndicated credit transaction. It may be easily adapted to a non-syndicated transaction by substituting "Lender" for "Lenders" and for the "Administrative Agent."

The Administrative Agent (the "Secured Party") must ensure that the accounts in question fit the Article 9 definition of "deposit account"²¹³ and are actually maintained by a bank.²¹⁴ The above statements are the Depositary Bank's representations to that effect.

The Depositary Bank should require an acknowledgment that the Deposit Agreement governs the Depositary Bank's depository relationship with the Grantor. Although the Deposit Account Control Agreement may override certain provisions of the Deposit Agreement with respect to the Depositary Bank's obligations to the Secured Party (e.g., set-off rights, etc.), the Deposit Agreement remains the controlling agreement with respect to the relationship between the Depositary Bank and the Depositor.

Note that the definition of "Controlled Accounts" describes the contents of each of the deposit accounts as well as the actual account itself.

B. Grant of Security Interest

SECTION 1. The Lenders have agreed to extend certain financing arrangements to the Grantor [or parent of the Grantor], and, in consideration for the Lenders' extension of value to the

213. "Deposit account" means a time, demand, savings, passbook, or similar account maintained with a bank." U.C.C. § 9-102(a)(29) (2000).

214. "Bank" means "an organization that is engaged in the business of banking ..." and includes "savings banks, savings and loan associations, credit unions, and trust companies." U.C.C. § 9-102(a)(8) (2000).

Grantor, the Grantor grants to the Administrative Agent a senior lien and security interest, for the ratable benefit of itself and the other Lenders, in the Controlled Accounts and all cash and non-cash proceeds of the Controlled Accounts and all cash and non-cash proceeds of any other collateral security pledged by the Grantor to secure its obligations to the Administrative Agent and Lenders under the [Credit Agreement] [Other Applicable Loan Documents].

Commentary

In this Section, the Grantor grants a security interest in the Controlled Accounts in favor of the Secured Party, to the extent that the Credit Agreement or other applicable Loan Documents do not grant a security interest or the transaction is otherwise unsecured.

C. Confirmation of Type of Collateral

The Grantor and the Depositary Bank represent and warrant to the Administrative Agent that the Controlled Accounts (i) are not evidenced by an instrument (as that term is defined in the UCC), and (ii) do not constitute a securities account or contain securities or investment property (as such terms are defined in the UCC).

Commentary

A creditor perfects a security interest in an instrument by possession²¹⁵ or filing.²¹⁶ It perfects an interest in securities, securities accounts, and investment property by possession and assignment or by filing for certificated securities,²¹⁷ or control or filing with respect to uncertificated securities and securities accounts.²¹⁸ Perfection of a security interest in a deposit account as original collateral requires control.²¹⁹ To make sure it is following

215. U.C.C. § 9-313(a) (2000).

216. U.C.C. § 9-312(a) (2000).

217. U.C.C. § 9-313(a); § 9-312(a) (2000).

218. U.C.C. § 9-314(a) (2000).

219. U.C.C. § 9-312(b) (2000).

the correct perfection steps, the Secured Party must ensure that the deposit account is actually a deposit account and not some other type of collateral. For example, the cash management account that the Secured Party thinks is a deposit account might actually be a money market account which would constitute a securities account, not a deposit account.²²⁰ Similarly, under Article 9, a certificate of deposit that is “of a type that in ordinary course of business is transferred by delivery with any necessary indorsement or assignment” is an instrument, *not* a deposit account.²²¹ Conversely, uncertificated certificates of deposit which are not evidenced by a writing and non-negotiable certificates of deposit which are not instruments, are probably deposit accounts.²²²

D. Other Deposit Accounts of the Grantor

The Grantor represents and warrants to the Administrative Agent that (i) the Controlled Accounts are the only deposit accounts of Grantor (ii) Grantor shall deposit all proceeds derived from the sale or other disposition of any of its assets into only those Controlled Accounts and (iii) Grantor will not open or establish any deposit accounts other than the Controlled Accounts.

Commentary

The Secured Party should ensure that it has control of all the Grantor's deposit accounts so that it holds a first priority security interest wherever the Grantor maintains funds. The Secured Party wants the Grantor's representation that it has not established and will not establish any other deposit accounts and that the Grantor will deposit all of its cash only into those accounts in which the Secured Party holds a first priority security interest.

220. See U.C.C. § 9-102 official cmt. 12 (2000).

221. *Id.*

222. *Id.*

E. Control

SECTION 2.

(a) By their execution of this Agreement, the Grantor and the Administrative Agent authorize and direct the Depositary Bank, and the Depositary Bank agrees, that following the Depositary Bank's receipt of a notice of default (a "Notice of Default") from the Administrative Agent stating that a default or event of default has occurred under the Credit Agreement,

(i) unless prohibited by applicable law, the Depositary Bank, without the Grantor's further consent, will comply with all instructions originated by the Administrative Agent directing disposition of funds in the Controlled Accounts;

(ii) only the Administrative Agent shall have the ability (without the Grantor's consent or agreement) to withdraw, or direct the withdrawals of, funds from the Controlled Accounts;

(iii) the Grantor shall have no right to exercise any authority of any kind with respect to the Controlled Accounts or the funds deposited in the Controlled Accounts;

(iv) upon the request of the Administrative Agent (without the Grantor's consent or agreement), the Controlled Accounts will be transferred to and maintained in the name of the Administrative Agent; and

(v) by their execution of this Agreement, the Grantor and the Administrative Agent authorize and direct the Depositary Bank to forward collected funds from the Controlled Accounts to, or as directed by, the Administrative Agent until further notice from the Administrative Agent.

The Depositary Bank represents to the Administrative Agent that it has not previously entered into and agrees that it will not enter into any other control agreement with respect to the Controlled Accounts.

Commentary

This section contains the operative control provisions required by the UCC.²²³ Note the Secured Party can have control even though the Grantor is permitted to access the deposit account until the Depositary Bank receives a Notice of Default.²²⁴ The agreement should establish that the Depositary Bank is not required to obey the Secured Party's instructions if to do so would cause the Depositary Bank to violate any law or regulation, e.g., to violate the automatic stay in the event of Grantor's bankruptcy. Hence, clause (i)'s qualifying language.

Because the existence of a control agreement is a "secret lien," the Secured Party should obtain the Depositary Bank's confirmation that it has not previously entered into a control agreement with respect to the Controlled Accounts and it will not do so in the future.

F. Copies of Account Statements

(b) The Depositary Bank agrees to deliver copies of all correspondence, notices, and account statements or other information which the Depositary Bank is otherwise obligated to send to the Grantor (by law, agreement or otherwise) to the Administrative Agent by regular U.S. mail at the address specified below. All additional costs and expenses the Depositary Bank incurs in connection with this Section 2(b) shall be deemed to be Fees.

Commentary

The Secured Party wants copies of all notices and statements the Depositary Bank sends to the Grantor so it can monitor the status of the Controlled Accounts and become aware of any unusual activities such as returned items, overdrafts or large withdrawals. The Depositary Bank may wish to limit this obligation to notices and statements the Secured Party requests or notices and statements the Depositary Bank sends to the Grantor after a Notice of Default has been issued. In any event, the

223. U.C.C. § 9-104(a)(2) (2000).

224. U.C.C. § 9-104(b) (2000); see U.C.C. § 9-104 official cmt 3.

Grantor or Secured Party should compensate the Depository Bank for this additional expense.

G. Waiver of Right of Set-Off and Subordination of Security Interest by the Depository Bank

SECTION 3. So long as this Agreement is in effect and notwithstanding the terms and provisions of the Deposit Agreement to the contrary, the Depository Bank (i) waives and relinquishes any right of set-off, right of recoupment or banker's lien with respect to the Controlled Accounts, except to the extent specifically permitted in Section 4, and (ii) subordinates any lien or security interest it may now or hereafter have or claim in the Controlled Accounts or in any cash or non-cash proceeds of the Controlled Accounts to the lien and security interest of the Administrative Agent in the Controlled Accounts.

Commentary

Although not required for control under the UCC, this Section contains one of the most important provisions of an effective Deposit Account Control Agreement. A Depository Bank automatically holds a right of set-off against the Controlled Accounts²²⁵ and likely holds a security interest in the Controlled Accounts, both of which are superior to a security interest of other secured parties.²²⁶ The Secured Party should require the Depository Bank to specifically waive its right of set-off and subordinate its security interest to that of the Secured Party. Because it is unreasonable to expect the Depository Bank to agree to waive its right of set-off with respect to fees and expenses related to the deposit account and with respect to returned items, these items are carved out of the waiver and subordination provisions to the extent set forth in Section 4 of the Deposit Account Control Agreement.

225. U.C.C. § 9-340; U.C.C. § 9-340 official cmt. 2 (2000).

226. U.C.C. § 9-340(a)-(b) (2000).

H. Limited Right of Set-Off and Indemnification of the Depositary Bank

SECTION 4. The Depositary Bank may offset and charge the Controlled Accounts for (i) any items deposited in the Controlled Accounts which are returned or charged back for any reason or are otherwise not collected, (ii) reversals or cancellations of payment orders and other electronic fund transfers, (iii) all service charges, fees, expenses and other items ("Fees") customarily chargeable with respect to the Controlled Accounts (the items in clauses (i) and (ii), together with the Fees, the "Charges"). If there are insufficient funds in the Controlled Accounts to pay the Charges, or if applicable law prohibits the Charges, then the Grantor agrees to pay all Charges to the Depositary Bank promptly after written notice by the Depositary Bank to the Grantor (with a copy to the Administrative Agent). To the extent the Charges are not paid by the Grantor within five (5) days after such written notice, then the Administrative Agent agrees to pay such Charges to the Depositary Bank; provided that (i) the Administrative Agent's obligation to make such payment shall be limited to [the proceeds of the Controlled Accounts actually received by the Administrative Agent during the immediately preceding ninety (90) days] [(a) all outstanding Fees and (b) all other Charges for the immediately preceding sixty (60) days] and (ii) the Administrative Agent shall have received written demand for payment from the Depositary Bank. The Grantor and the Administrative Agent acknowledge that the Grantor is obligated to pay all customary and reasonable fees and service charges of the Depositary Bank resulting from operation of the Controlled Accounts. The Grantor agrees to promptly reimburse the Administrative Agent and the Lenders for any monies that the Administrative Agent may forward to the Depositary Bank in settlement and satisfaction of any Charges detailed above. The Depositary Bank agrees to accept cash payment in lieu of balances as compensation for fees and service charges incurred on or normally charged to the Controlled Accounts. Except as expressly set forth in this Section 4, the Administrative Agent shall have no obligation to reimburse the Depositary Bank for any such unpaid Charges.

Commentary

The Depositary Bank will usually insist upon a limited right of set-off against the deposit account to reimburse itself for fees and expenses incurred in connection with the deposit account and to cover any items that are deposited in the account for which the Depositary Bank has given provisional credit but which are subsequently returned unpaid. If there are insufficient funds in the Deposit Account, the Grantor is primarily responsible for reimbursing the Depositary Bank. Most Deposit Account Control Agreements provide that if the Grantor does not reimburse the Depositary Bank within a certain time frame, the Secured Party must do so. This is an important credit support mechanism for the Depositary Bank which attorneys should not overlook. Without an indemnity by the Secured Party, which is typically a highly credit-worthy financial institution, the Depositary Bank is left to pursue the Grantor in the event of insufficient funds in the deposit account. If the Grantor is insolvent, the Depositary Bank may be out of luck. This credit support may increase the value of the Deposit Account Control Agreement to the Depositary Bank and may be enough to sway a reluctant Depositary Bank to enter into the Deposit Account Control Agreement. Nevertheless, the Secured Party should attempt to limit its indemnity and reimbursement obligations to the amount of proceeds it has received from the Controlled Accounts or to fees and expenses relating to the deposit account that have accrued over a defined, limited period of time.

I. Indemnities

SECTION 5. The Grantor agrees to indemnify, defend and hold harmless the Depositary Bank against any and all loss, cost, liability, and expense, including, without limitation, the Charges and the reasonable fees and disbursements of counsel, incurred in connection with this Agreement and the Controlled Accounts or incurred at the Grantor's direction, unless the Depositary Bank's gross negligence or willful misconduct caused such loss, cost, liability, or expense. The Grantor and the Administrative Agent agree that absent the Depositary Bank's gross negligence or willful misconduct, the Depositary Bank shall have no liability to either of them for any loss or damage that either or both may claim to have

suffered or incurred, either directly or indirectly, by reason of this Agreement or any transaction or service contemplated by the provisions hereof. In the absence of gross negligence or willful misconduct on the part of the Depositary Bank, the Grantor agrees to assume all risk of loss associated with the Controlled Accounts. In no event shall the Depositary Bank incur any liability for any claims, losses, delays, or interruptions of any nature resulting from computer malfunction, interruption of communication facilities, labor difficulties, civil disobedience or disruption, acts of terrorism or war, or any other causes whatsoever beyond the Depositary Bank's control. In no event shall the Depositary Bank be liable for special, indirect, exemplary, consequential, or punitive damages.

Commentary

The Depositary Bank does not want to increase its potential for liability to the Grantor or incur potential liability to others simply by agreeing to become a party to the Deposit Account Control Agreement. Typically, it will insist that it not incur any liability for following the terms of the Deposit Account Control Agreement for any reason other than its own gross negligence or willful misconduct. Additionally, the Depositary Bank will usually require the Grantor and the Secured Party to indemnify the Depositary Bank against all other liability it incurs by complying with the terms of the Deposit Account Control Agreement.

J. Termination

SECTION 6. The Grantor may terminate this Agreement (i) with the express prior written consent of the Administrative Agent, and in that case the Administrative Agent and the Grantor shall jointly notify the Depositary Bank of such termination, and (ii) at any time after the Administrative Agent ceases to have a security interest in the Controlled Accounts; provided, that no such termination by the Grantor shall be effective unless the Depositary Bank shall have received a written notice from the Administrative Agent confirming that such security interest no longer exists. The Administrative Agent may terminate this Agreement at any time upon its delivery of written notice of such termination to the Depositary Bank. Notwithstanding anything to the contrary

contained in the Deposit Agreement, the Depositary Bank may terminate this Agreement at any time on not less than thirty (30) days' prior written notice of such intention delivered by it to each of the Grantor and the Administrative Agent [except in the event of any act of fraud or violation of applicable law by the Grantor with respect to the Controlled Accounts, in which event the Depositary Bank may immediately terminate this Agreement]. The Depositary Bank's reimbursement and indemnity rights against the Grantor under Section 4 and Section 7 and against the Administrative Agent under Section 4 shall survive the expiration or any termination of this Agreement. Upon any termination of this Agreement, the Depositary Bank shall forward all net funds remaining in the Controlled Accounts, after deduction by the Depositary Bank of the outstanding Charges directly to the Administrative Agent unless the Depositary Bank receives written notification in accordance with Section 8 from the Administrative Agent prior to the expiration of the thirty (30) day period directing all net funds remaining in the Controlled Accounts to another depository institution approved by Administrative Agent. The termination of this Agreement shall not terminate the Controlled Accounts or alter the obligations of the Depositary Bank to the Grantor pursuant to any agreement with respect to the Controlled Accounts.

Commentary

The termination provisions are important to the Secured Party. It wants to ensure that the Deposit Account Control Agreement is not terminated without its prior written consent or, at the least, without its prior knowledge. Such a termination would result in the immediate loss of perfection of its security interest²²⁷ and accompanying loss of priority and other intercreditor agreements with the Depositary Bank. Therefore, when the Depositary Bank terminates the agreement, termination may only occur after the Depositary Bank delivers at least 30 days prior written notice to the Secured Party. This allows the Secured Party sufficient time to make other deposit account arrangements with the Grantor. The Depositary Bank may wish to have a right of immediate termination in limited circumstances. The Secured

227. U.C.C. § 9-314(b) (2000) (creditor's interest becomes perfected when it obtains control and only remains perfected while the creditor retains control).

Party may vigorously oppose this. However, the Depositary Bank will want the ability to extricate itself if the Grantor commits any act of fraud or illegality with respect to the deposit account.

K. Reliance upon Secured Party's Instructions

SECTION 7. The Depositary Bank shall be entitled to rely conclusively upon any notice or instruction it receives from the Administrative Agent and the Depositary Bank shall have no obligation to investigate or verify the authenticity or correctness of any such notice or instruction. The Depositary Bank shall have no liability to the Grantor for the Depositary Bank's honoring of any instructions or directions regarding the Controlled Accounts which the Depositary Bank receives from the Administrative Agent during the term of this Agreement, and the Depositary Bank shall be fully discharged from liability with respect to any funds on deposit in the Controlled Accounts to the extent it honors such instructions and transfers the same to, or at the direction of, the Administrative Agent.

Commentary

It is important to the Depositary Bank that its actions in response to the Secured Party's directions be purely ministerial in nature and not subject to second-guessing. Therefore, it will typically insist on the right to rely upon any instruction from the Secured Party without further investigation or verification on its part. So, too, it will want to disclaim any liability to the Grantor for following the Secured Party's directions.

Disclaimers regarding the depositary bank's liability for following the secured party's instructions are particularly important. Assume the secured party orders the depositary bank to freeze the account. As a result, the depositary bank dishonors several of the depositor's checks. If the customer-depositor successfully argues the depositary bank wrongfully dishonored its checks,²²⁸ the bank will be liable for all damages proximately caused.²²⁹ Wrongful dishonor liability is potentially open-ended.

228. U.C.C. § 4-402 (1990).

229. U.C.C. § 4-402(b) (1990).

The Deposit Accounts Task Force recommended to the Article 9 Drafting Committee that it add “[a] comment indicating that dishonor pursuant to or following Lender’s instructions is not wrongful.” The Drafting Committee made no change in response and the Official Comments do not address it.”²³⁰

L. Notices

SECTION 8. All notices or other communications required or provided under this Agreement shall be in writing and shall be sent to each party at its respective address and shall be issued by or directed to the designated officer (the “Designated Officer”) set forth beneath its signature below (or at such other address and to or by such other Designated Officer as such party may designate in writing to the other parties). Such notices or communications shall be effective on the date actually received by the Designated Officer if received prior to 12:00 noon (Eastern time) on any business day of the Depositary Bank. If received by the Designated Officer after 12:00 noon (Eastern time), or if received by the Designated Officer on a non-banking day, such notice or communication shall be effective on the immediately succeeding banking day of the Depositary Bank.

Upon receipt of a Notice of Default, the Depositary Bank shall determine, on each day which is a banking day, the balance of all collected funds in the Controlled Accounts, and shall wire transfer through the federal reserve system all such collected funds on deposit in the Controlled Accounts not later than 2:00 P.M. (Eastern time) on such day to the account the Administrative Agent designates in writing from time to time.

A payor bank is liable to its customer for damages proximately caused by the wrongful dishonor of an item. Liability is limited to actual damages proved and may include damages for an arrest or prosecution of the customer or other consequential damages. Whether any consequential damages are proximately caused by the wrongful dishonor is a question of fact to be determined in each case.

Id.

230. Hilson, et. al., *supra* note 46, at 206.

Commentary

Note that following the Depositary Bank's receipt of a Default Notice, it must institute a daily sweep of funds in the Controlled Accounts directly to the Secured Party.

M. Governing Law

SECTION 10. This Agreement shall be governed by the laws of the State of _____ (without giving effect to its conflicts of law rules) and such State shall be the jurisdiction of the Depositary Bank for purposes of Section 9-304(b)(1) of the UCC.

Commentary

As with all security interests, it is important for the parties to know with certainty which state's law will govern perfection and priority of the Secured Party's security interest in a deposit account. Revised Article 9 has simplified this task by permitting the parties to a deposit account control agreement to designate the Depositary Bank's jurisdiction²³¹ for purposes of determining the applicable local law that will govern perfection and priority of a security interest in the deposit account.²³² If the deposit account control agreement does not select a jurisdiction, then a selection of jurisdiction in any agreement governing the Deposit Account shall control.²³³ Failing any written agreement with respect to jurisdiction, the Depositary Bank's jurisdiction is the jurisdiction in which the office identified in the account statement as the office serving the customer's account is located.²³⁴ The Depositary Bank will most likely desire to elect the jurisdiction of the office where the deposit account was established or that of its principal office. To avoid potential conflict of law issues, the Secured Party must make sure it does not agree to a jurisdiction that is inconsistent with the jurisdiction set forth in its credit documents.

231. U.C.C. § 9-304(b)(1) (2000).

232. U.C.C. § 9-304(a) (2000).

233. U.C.C. § 9-304(b)(2) (2000).

234. U.C.C. § 9-304(b)(4) (2000).

